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Teri L. K. Shugart

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Yours, Mine and Ours: A Proposal to Bring Certainty to the Use of Personal Goodwill in the Sale of Assets of a C Corporation

Teri L.K. Shugart*

I. INTRODUCTION

Since the seminal case of *Martin Ice Cream*¹ in 1998, certain shareholders of closely held² C corporations³ have had the opportunity to avoid, in part, double taxation⁴ on the sale of their corporation's assets by allocating some or all of the purchase price to "personal goodwill," i.e., goodwill owned personally by the shareholder rather than by the corporation. Both the corporation and the shareholder benefit from this allocation: first, the corporation will be able to report less in proceeds, which then reduces the amount of taxes it will pay on the sale.⁵ Second, the shareholder will have long term capital gains treatment⁶ on the proceeds without the proceeds first being subjected to a corporate tax. The buyer has no dog in this hunt—it will amortize the goodwill over 15 years regardless

* Tax and Business Attorney, San Carlos, Calif., and Adjunct Lecturer at University of Santa Clara, School of Law

1. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 189 (1998).

2. "Closely held" does not necessarily mean that the business is small in revenue or net worth. It only means that there are very few owners. As of 2012, the most recent year for which we have data, 41% of all businesses in the United States had only one owner. www.census.gov/econ/sbo/.

3. Section 1361(a)(2) of the Code defines a "C corporation" as "a corporation which is not an S corporation." I.R.C. § 1361(a)(2). In other words, a C corporation is the default setting for corporations.

4. "Double taxation" is the idea that a corporation is first taxed on the proceeds it receives in a transaction, and then the shareholders are taxed on the net proceeds they receive from the corporation. For example, assume a corporation is selling assets for \$100,000, which assets have a basis of \$30,000. The net proceeds to the corporation are \$70,000. Assuming a corporate tax rate of 35%, the corporation will pay \$24,500 in taxes, and then will distribute out the remainder as a dividend (\$45,500) to its shareholder. Assuming a dividend tax rate of 20%, its shareholder will pay \$9,100 in taxes, leaving its shareholder with a net \$36,400. See also Part II.B, *infra*.

5. In addition, corporations do not receive the benefit of long term capital gains treatment that are enjoyed by individuals. All proceeds are taxed as ordinary income. I.R.C. § 11.

6. This assumes that the shareholder has owned their stake in this company for at least a year, which would normally be the case given the criteria for allocating personal goodwill.

of from whom it was purchased.⁷

The problem with allocating proceeds to personal goodwill is that it is not risk free. Despite case law⁸ and commentary⁹ that show a generally understood list of criteria¹⁰ necessary for a seller to take advantage of an allocation of personal goodwill, its promotion always comes with caveats: the Internal Revenue Service (the “Service”) does not like it,¹¹ following the criteria just reduces the risk of it being respected by the Service,¹² and the criteria aren’t foolproof – they’re just a good defense from a Service challenge,¹³ just to name a few. Added to that problem is that the criteria are not as carved in stone as some of the commentators seem to assert; rather, these cases are covered in a patina of judges’ feelings about personal goodwill or the behavior of the litigants.

This article examines in depth the individual cases that came after and relied on *Martin Ice Cream*, and then challenges the criteria that others have determined have been suggested by those cases. Last, this article suggests a legislative fix (similar to the problem that section 197 was created to fix)¹⁴ to make clear the criteria for allocation of personal goodwill, which would reduce litigation and give certainty in this area of law.

II. GOODWILL – BACKGROUND

A. WHAT IS GOODWILL?

To understand personal goodwill, an understanding of goodwill, by itself, is important. Goodwill is an intangible asset of a business¹⁵ that

7. I.R.C. § 197.

8. See Part IV, *infra*.

9. See, e.g., Darian M. Ibrahim, *The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions*, 30 DEL. J. CORP. L. 1 (2005); Bret Wells & Craig Bergez, *Disposable Personal Goodwill, Frosty the Snowman, and Martin Ice Cream All Melt Away in the Bright Sunlight of Analysis*, 91 NEB. L. REV. 170 (2012).

10. See, e.g., Jeffrey M. Risius & Aaron Stumpf, *Another Tax Court Case Addresses the Question of Whether Identified Intangible Value Is Business Goodwill or Personal Goodwill*, SRR JOURNAL, last accessed Sept. 4, 2016, <http://www.srr.com/article/another-tax-court-case-addresses-question-whether-identified-intangible-value-business-goodw>.

11. Peter J. Reilly, *Personal Goodwill Avoids Corporate Tax Exposure*, FORBES, June 13, 2014, <http://www.forbes.com/sites/peterjreilly/2014/06/13/personal-goodwill-avoids-corporate-tax-exposure/#3cb0de6321b4>.

12. Timothy M. Todd, *Whose Goodwill Is It? The Taxation of Goodwill in Owner-Entity Transactions*, 122 J. TAX’N 74, 81 (2015).

13. Nick Gruidl, Amy Kasden & Peter Enyart, *Personal Goodwill: Alive and Well Indeed!*, TAX ADVISER, March 31, 2015, <http://www.thetaxadviser.com/issues/2015/apr/tax-clinic-07.html>.

14. Jack S. Levin & Donald E. Roca, *A Transactional Guide to New Code Section 197*, TAX NOTES, Oct. 25, 1993, at 474. See Part III, *infra*.

15. An intangible asset is a non-physical asset that has value. It “derives its value not from physical attributes, but from its intellectual content or other intangible properties.” I.R.M. 4.48.5.1.

comes into existence when the assets of a company are being purchased.¹⁶ In its simplest terms, goodwill is the difference between the purchase price of all of a company's assets and the fair market value of a company's tangible assets.¹⁷ For example, if Company A purchased the assets of Company B for \$500,000, yet the fair market value of only the tangible assets¹⁸ was \$400,000, the remaining \$100,000 would be allocated to goodwill.¹⁹ The meaning behind an allocation of goodwill to part of a purchase price of assets is that the goodwill has value: it is "the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor."²⁰ However, this definition is statutorily fairly new, having been enacted only in 2000, in a regulation under section 197.²¹ Section 197 itself was only enacted in 1993.²² Prior to 2000, goodwill was not otherwise defined in the United States Code, including the Internal Revenue Code (the "Code"),²³ nor in any other United States regulation.²⁴ Commentators frequently noted the lack of a definition.²⁵

But courts and professionals had defined goodwill prior to 2000—the concept has been used for accounting purposes since at least 1874,²⁶ for legal and tax purposes at least since 1893²⁷ and as a part of the value of a professional business in a division of marital assets at least since 1956.^{28,29}

16. The concept is also used in the divorce context when valuing the assets of a business for the division of property. Goodwill as used in that context is beyond the scope of this Article.

17. ROBERT B. DICKIE, FINANCIAL STATEMENT ANALYSIS AND BUSINESS VALUATION FOR THE PRACTICAL LAWYER 72 (2d ed. 2006).

18. Tangible assets are physical assets, and can be further broken down between fixed assets (e.g., buildings, machinery) and current assets (e.g., inventory).

19. The excess of purchase price over fair market value can also be allocated to other intangible assets, provided that those assets are capable of being separated from the business itself, e.g., a patent. See text accompanying note 73, *infra*. However, the generic definition stated above is the most used and commonly understood definition.

20. Reg. § 1.197-2(b)(1).

21. *Id.*

22. I.R.C. § 197.

23. Newark Morning Ledger Co. v. United States, 507 U.S. 546, 555 (1993).

24. All definitions of goodwill in the regulations refer to Regulation section 1.197-2(b)(1). See, e.g., Reg. 1.263(a)-4(c)(1)(x).

25. See Matthew A. Melone, *Section 197 Complicates Planning for Retiring LLC Members*, 58 TAX'N FOR ACCT. 292, 297 (1997) ("Admittedly, precise definitions of goodwill are elusive, as evidenced by the regulations under sections 338 and 1060. These regulations, governing the allocation of purchase price among multiple assets, define goodwill residually as the amount left over after allocation of amounts to all other assets, which, of course, just begs the question of what exactly is goodwill.").

26. HUGH P. HUGHES, GOODWILL IN ACCOUNTING: A HISTORY OF THE ISSUES AND PROBLEMS (1982).

27. Metro. Nat'l Bank v. St. Louis Dispatch Co., 149 U.S. 436, 448 (1893).

28. Mueller v. Mueller, 144 Cal. App. 2d 245, 250 (1956).

29. 24 AM. JUR. 2D *Divorce & Separation* § 547 (2016). In this context, the value of goodwill can

B. TAX CONSEQUENCES FOR A C CORPORATION³⁰ SELLER OF ASSETS GENERALLY

When a C corporation sells its assets, the profit it makes on the sale is taxed to the corporation (as opposed to the individual shareholders). The rate of corporate income tax ranges between 15% and 39%.³¹ The profit remaining after the payment of taxes is then available for distribution to the shareholders. After distribution to the shareholders, the shareholders are taxed on that distribution at their individual income tax rates. This is the idea of double taxation³² in a nutshell: the corporation first pays a tax on its net income, and then the shareholders pay another tax on the remaining net income.³³ Contrast this with the tax effects on owners of pass-through entities:³⁴ pass-through entities aren't taxed at the entity level, so owners of pass-through entities are taxed only once on the net income

be used to justify an unequal division of assets, which division might not hold up in an accounting or tax context. Also, goodwill in a marital context is usually determined by state law. In any event, this type of goodwill is beyond the scope of this article.

30. A corporation is an entity formed under state law. A corporation's tax status is determined by the Code. By default, for tax purposes, a corporation is a "C" corporation. I.R.C. §§ 11, 1361(b). Corporations wishing to have a different tax status (the most common is an S corporation) must form as a corporation under state law, and then elect to have a different tax status by filing a form with the Service. See, e.g., IRS Form 2553, Election by a Small Business Corporation.

31. The rates for 2015 were:

For taxable income over	But not over	The tax rate is
\$0	\$50,000	15%
\$50,000	\$75,000	25%
\$75,000	\$100,000	34%
\$100,000	\$335,000	39%
\$335,000	\$10,000,000	34%
\$10,000,000	\$15,000,000	35%
\$15,000,000	\$18,333,333	38%
\$18,333,333	-----	35%

I.R.C. § 11.

32. Corporate distributions of assets (or the cash available after the sale of those assets) to its shareholders were not always taxed. Under the *General Utilities* doctrine, a corporation recognized no gain or loss on the distribution of appreciated property to its shareholders. *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935). This benefit eroded over time, until the doctrine was completely repealed by the passage of the Tax Reform Act of 1986. Pub. L. No. 99-514, 100 Stat. 2085. In addition, corporations were prevented from circumventing the repeal of the *General Utilities* doctrine by converting into an S corporation before distributing appreciated assets to its shareholders, by imposing a corporate level tax on distributions made within 10 years of the conversion to S corporation status. I.R.C. § 1374.

33. This assumes that the corporation distributes the remaining net income to the shareholders. The corporation may choose to reinvest the money, e.g., expansion or new equipment. Until a corporation distributes net income (or any income or asset) to the shareholders, the shareholders are not taxed on it.

34. A pass-through entity is a sole proprietorship, a limited or general partnership, a limited liability company or an S corporation. In other words, a C corporation is the only business entity form that has a double level of taxation. However, some states do assess an entity level tax on pass-through entities, e.g., California.

from that pass-through entity.³⁵

All things being equal,³⁶ it is always more economically advantageous for owners to receive income from a sale of assets as an owner of a pass-through entity rather than as an owner of a C corporation. The simplistic example below, in which a corporation sells its assets for a net (pre-tax) \$11,000,000,³⁷ shows how a pass-through entity owner would end up with \$3,080,000 more than an owner of a C corporation:

	<i>C Corporation</i>	<i>Pass Through Entity</i>
Net income from sale of assets	\$11,000,000	\$11,000,000
Less 35% corporate tax ³⁸	\$3,850,000	0
Net income available to shareholders	\$7,150,000	\$11,000,000
Less 20% qualified dividend rate ³⁹	\$1,430,000	\$ 2,200,000
Net income to shareholders after taxes	\$5,720,000	\$ 8,800,000

C. TAX CONSEQUENCES FOR BUYER OF ASSETS FROM A CORPORATION⁴⁰

A buyer of assets from a corporation can have two financial benefits from the purchase of those assets. First, the buyer gets a step up in basis for the assets purchased,⁴¹ and second, the buyer can expense (deduct)⁴²

35. The one downside to net income from a pass-through entity is that the owners will be taxed on the net income, even if the company does not distribute it out to the owners.

36. And it is never equal. A sale of assets can have considerations that go far beyond tax consequences.

37. The \$11,000,000 figure was used to secure a high tax rate. *See supra* note 31.

38. This 35% tax rate is an approximation. *See supra* note 31.

39. The qualified dividend rate is the same as the capital gains rate. I.R.C. § 1(h)(11). For people with high incomes, the highest capital gains rate is 20%. § 1(h)(1)(D).

40. Whether or not the seller of assets is a C corporation or an S corporation has no effect, tax-wise, for the buyer. In fact, the effect on the buyer of assets will be the same no matter what form of entity of the seller, including limited liability companies, partnerships or sole proprietorships.

41. This result is different to the one a buyer gets from the purchase of stock. As with purchases for most assets, an asset's basis for a purchaser is the fair market value on the date of acquisition, which is generally the amount that the purchaser paid for those assets. The benefit to the purchaser accrues when the purchasing corporation sells those assets to a third party: the gain for the purchasing corporation is the amount they receive for those assets from the third party less the amount they paid for those assets. For example, if a selling corporation sold assets worth \$1,000,000, but those assets had a basis of \$400,000 in the hands of the selling corporation, those assets would then have a basis of \$1,000,000 for the purchaser. Then assume that the purchasing corporation sold the assets to a third party for \$1,300,000. The purchasing corporation would only have a \$300,000 gain. However, if the purchasing corporation had purchased the stock of the selling corporation rather than its assets, and the corporation sold the assets for \$1,300,000, the purchasing corporation would have a \$900,000 gain: the third party selling price (\$1,300,000) less the carry over basis from the selling corporation (\$400,000).

42. The idea is that assets don't last forever, so a company can deduct, as an expense, the cost of

some of the purchase price of some of the assets via depreciation⁴³ and amortization.⁴⁴

III. I.R.C. SECTION 197

A. PRE-SECTION 197

Prior to 1993,⁴⁵ allocating part of the purchase price to intangible assets in an asset purchase was fraught with the risk of litigation.⁴⁶ Only intangibles that had a limited life that could be ascertained with reasonable accuracy could be amortized,⁴⁷ and goodwill was not amortizable at all.⁴⁸ Therefore, the more that was allocated to goodwill equaled a higher effective purchase price of the assets, as the buyer couldn't deduct any of the amount allocated to goodwill. The Service frequently challenged allocations to intangibles other than goodwill, taking the position that the purchaser-identified non-goodwill intangible assets were really goodwill.⁴⁹ A secondary problem was that the regulations didn't define the useful life of many intangible assets,⁵⁰ so the allocation for each individual intangible

those assets over the useful life of those assets. The useful life of assets is statutorily proscribed in the Code. See I.R.C. § 168. For example, office furniture is considered to have a useful life of 7 years, and nonresidential real property used in a business to have a useful life of 39 years. § 168.

43. "Depreciation" is the word used for deducting the cost of certain tangible assets over that asset's useful life. See I.R.C. § 167(a); Reg. § 1.167(a)-1. Common examples of depreciable assets include equipment, office furniture, trucks and buildings. Common examples of non-depreciable tangible assets include inventory and land.

44. "Amortization" is the word used for deducting the cost of certain intangible assets over that asset's useful life, as well as certain business costs. Common examples of amortizable assets include goodwill, patents, and trademarks; and examples of amortizable business costs include start-up costs and the costs of research and development. In addition, there are some assets that can only be amortized if purchased, e.g., goodwill. See Chapter 8, Amortization, in the Service's Publication 535, for a more in-depth discussion of this topic. I.R.S. PUBLICATION 535, BUSINESS EXPENSES, *Amortization*, (Jan. 7, 2016).

45. Section 197 of the Code was enacted in 1993.

46. Gregory M. Beil, Comment, *Internal Revenue Code Section 197: A Cure for the Controversy Over the Amortization of Acquired Intangible Assets*, 49 U. MIAMI L. REV. 731, 733 (1995).

47. § 167.

48. See Reg. § 1.167(a)-3 ("If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.") (emphasis added).

49. See *Hous. Chronicle Publ'g Co. v. United States*, 481 F.2d 1240, 1247 (5th Cir. 1973) (outlining several cases where taxpayers were unsuccessful in appealing for an amortization deduction).

50. However, the regulations under section 197 do define the useful life of some intangibles, e.g.,

asset had to be supported, which involved costly appraisals and expert opinions.⁵¹ As the Code and regulations had so little guidance on what an amortizable intangible was, the courts ended up developing the definitions, which then evolved into the idea that an amortizable intangible asset had to have an ascertainable value that was separate from any other asset, including goodwill, and had a limited and determinable life.⁵² And, even with expert opinions and statistical information, the answers were never clear, and the Service seemed to challenge them all.⁵³ The issues involved (a) whether certain intangibles could be amortized at all,⁵⁴ (b) if certain intangibles had a “reasonably ascertainable useful life”⁵⁵ and (c) how to allocate the purchase price of various intangibles.⁵⁶ A purchaser would want to have as many assets be amortizable as possible, using the shortest useful life available, and the Service would want as much of the intangible assets to be non-amortizable as possible. Chaos ensued.

The allocation of the purchase price to various intangible assets had an effect on the seller as well, in that the inability of the buyer to amortize a large part of the purchase price would decrease the amount that the buyer was willing to pay for the assets. In addition, as the seller would want to allocate as much of the purchase price as possible to assets with higher bases,⁵⁷ evaluating the allocation choices to arrive at an overall purchase price complicated the negotiations. Also, the parties would need to agree on the allocation of the purchase price to the various assets⁵⁸ and the scenarios had to take into account the risk of the Service not respecting the allocation.

On the eve of the passage of section 197,⁵⁹ the Supreme Court decided *Newark Morning Ledger v. United States*,⁶⁰ which opened the door to

patents, which were recoverable over a 17-year period. Before the enactment of section 197, the only code section that referenced amortization of intangibles was section 167, and the regulations thereunder. See Reg. § 1.167(a)-3.

51. Beil, *supra* note 46, at 736.

52. *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 565-66 (1993).

53. Government estimates from 1991 were that the Service had assessed \$8 billion against taxpayers who amortized intangibles that the Service claimed were goodwill. Estimates from 1993 show that the Service made over \$14.4 billion in proposed adjustments relating to amortization of intangible assets. Xuan-Thao N. Nguyen & Jeffrey A. Maine, *Taxing the New Intellectual Property Right*, 56 HASTINGS L.J. 1 (2004).

54. See, e.g., *Newark Morning Ledger*, 507 U.S. at 568.

55. *Id.*

56. *Id.*

57. The seller would want to allocate as much of the purchase price to assets with the highest bases, in order to reduce the amount of taxable gain.

58. Both the seller and the buyer file a IRS Form 8594, Asset Acquisition Statement Under Section 1060, in which each side allocates the purchase price to the various assets. Although there is no law that requires the amounts on the forms to agree, it would be a red flag if they did not.

59. The bill passed on August 6, 1993, and President Clinton signed it into law on August 10, 1993.

60. *Newark Morning Ledger*, 507 U.S. at 566.

allowing some intangible assets that might previously been thought of as goodwill to be amortizable, provided that those assets had an ascertainable value and a limited useful life. However, with the passage of section 197, the huge effect that this case could have had went away.⁶¹

B. IRC SECTION 197

Section 197 was added as a part of the Omnibus Budget Reconciliation Act of 1993 ("OBRA-93").⁶² The addition of section 197 added three major changes to the amortization of intangibles: first, it defined which intangibles were amortizable,⁶³ it now set a standard 15-year amortization schedule for section 197 intangibles,⁶⁴ and it allowed amortization of goodwill for the first time.⁶⁵ At first glance, section 197 saved money for a buyer of a business with intangible assets: the buyer no longer had the costs of experts to prove that the intangibles had a reasonably ascertainable life and how long that life was, and the buyer also no longer had the costs of litigation from the Service about the existence of intangibles or their useful life. The intangibles were defined in the regulations, and all intangibles were amortized over 15 years. Now, a buyer wouldn't care about the allocation between different intangibles, because all would be amortizable over 15 years.⁶⁶ However, other allocation problems arose.

61. On its face, it can look like the enactment of Omnibus Budget Reconciliation Act in 1993, Pub. L. 103-66, 107 Stat. 312, was a reaction to *Newark Morning Ledger*. See, e.g., Catherine L. Hammond, Note and Comment, *The Amortization of Intangible Assets: Section 197 of the Internal Revenue Code Settles the Confusion*, 27 CONN. L. REV. 915 (1995). However, Congress had been working on adding section 197 for several years, and passed the law on August 6, 1993. *Newark Morning Ledger* had only been decided four months earlier, on April 20, 1993.

62. Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, 107 Stat. 312. Also known colloquially as the Deficit Reduction Act of 1993, this Act was quite controversial at the time, as it raised the limit on personal income taxes to 39.6%, and corporations to 35%. It passed the Senate with a 51-50 vote, with Vice President Al Gore voting to break the tie. Roll Call Votes, U.S. SENATE, 103RD CONGRESS, 1ST SESS., Aug. 6, 1993, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=103&session=1&vote=00247. The addition of Section 197 was only a small part of the Act.

63. I.R.C. § 197(d). The section 197 intangibles, in addition to goodwill, are going concern value (§ 197(d)(1)(B)); workforce in place (§ 197(d)(1)(C)(i)); business records, including customer lists (§ 197(d)(1)(C)(ii)); patents and copyrights (§ 197(d)(1)(C)(iii)); customer-based intangibles (§ 197(d)(1)(C)(iv)); supplier-based intangibles (§ 197(d)(1)(C)(v)); and the catch-all phrase "any other similar item" (§ 197(d)(1)(C)(vi)); as well as governmental licenses and permits (§ 197(d)(1)(D)); covenants not to compete, but only in connection with an acquisition (§ 197(d)(1)(E)); and any franchise, trademark or trade name (§ 197(d)(1)(F)).

64. § 197(a).

65. § 197(d)(1)(A).

66. *Solomon v. Commissioner*, 95 T.C.M. (CCH) 1389, n.11 (2008).

C. ALLOCATION OF PURCHASE PRICE TO GOODWILL.

The acceptance of goodwill as an amortizable asset raised a different type of allocation problem for some buyers of assets. Often, when a buyer purchases the assets of a small business and those assets include goodwill, the terms of sale will almost always include some sort of covenant not to compete from the individual sellers of the business. The buyer will want to insure that the seller is not going to restart the same or a similar business down the road and compete with the just-purchased business. As goodwill includes “the expectancy of continued customer patronage,”⁶⁷ a covenant not to compete is the insurance that the expectancy will be fulfilled. As a result, goodwill and a covenant not to compete often go hand-in-hand in a sale of assets, and part of the purchase price has to be allocated between those two intangibles. The buyer will not care about the allocation between the two—both goodwill and a covenant not to compete are amortizable over a 15-year period. The seller, however, **will** care a great deal: goodwill is a capital asset⁶⁸ and the seller will only pay taxes on the amount allocated to goodwill at capital gains tax rates,⁶⁹ and, a covenant not to compete is taxed at ordinary income rates.⁷⁰

IV. PERSONAL GOODWILL AND THE CLOSELY HELD BUSINESS

A. OVERVIEW.

Goodwill is likely to be a part of the sale of a closely held business. Often, the owners are the ones on the front lines, running the day-to-day operations of the business. The owners have built up the business themselves, and have built customer loyalty based on personal relationships. When a buyer purchases a closely held business, it is often purchasing that customer loyalty, expecting that the customers will want to continue to patronize the same old business, even with new faces running it. The challenge for the buyer is how to keep customer loyalty when the customers are no longer seeing the old faces, especially when the owner is providing a professional service, e.g., an attorney, physician, dentist or real estate agent—there is only one face to the business, and it is the face of the one who is leaving. In those situations, it is often not enough to just have the owner agree to not compete with the business it is selling, the owner

67. Reg. § 1.197-2(b)(1).

68. See *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir.1963) (“It is settled that good will, as a distinct property right, is a capital asset under the tax laws.”).

69. This is true only if the seller is a pass-through entity or a sole proprietor. C corporations do not have capital gains tax rates.

70. *Commissioner v. Danielson*, 378 F.2d 771, 773 (3d Cir. 1967).

will also need to provide consulting services to the new owner, e.g., introducing the new owner to customers, suppliers and vendors, and community organizations. These consulting services also become part of the purchase price: the buyer agrees to pay the owner over time for the seller's time and effort in integrating the buyer into the seller's business. The seller will want to allocate as little of the purchase price as possible to the consulting agreement: not only will it be ordinary income, but it will also be subject to self-employment taxes.⁷¹ The buyer, on the other hand, will want as much of the purchase price as possible allocated to the consulting agreement: the buyer will be able to immediately deduct the payments made under the consulting agreement, as opposed to amortizing a covenant not to compete or goodwill over a 15-year period.

When the seller is a C corporation, that corporation will be indifferent to the various allocations between intangibles, as a C corporation has only one tax rate, so whether or not a gain is from a capital asset or a non-capital asset won't affect the tax assessed on the gain. The shareholders of that C corporation won't care either—they'll only bemoan the fact that the money available to be distributed to them is less because the C corporation had to first pay taxes on the sale.

As a result, a C corporation seller will normally prefer a stock sale rather than an asset sale: the C corporation shareholder will pay capital gains only on the difference between their basis in the stock and the amount they received for their stock from the buyer. However, a buyer **will not** prefer a stock purchase, because it will have paid out lots of money with nothing to immediately expense, and it will not get a step up in basis of the seller's assets. In addition, a buyer cannot pick and choose among assets when it is purchasing stock. Then, to add insult to injury, when that buyer eventually decides to sell its acquired assets, it is now going to have to pay a corporate tax on the difference between the sale price of the assets and the basis in the assets, which basis was not stepped up at the first sale.

B. PERSONAL GOODWILL

For a closely held C corporation that is selling its assets, there is a way for an owner (shareholder) of the corporation to avoid at least some of the double taxation associated with a sale of assets: to allocate some of the purchase price to the owner directly as personal goodwill, rather than the sale of goodwill held by the C corporation. That scenario allows some of the proceeds to avoid going through the corporation (avoiding the corporate tax) and be taxed at the capital gains tax rate of the owner.

Using the same example as in Section II.B. as a starting point, this second example shows how the owner of a C corporation benefits from a

71. I.R.C. § 1402(b).

personal goodwill allocation. First, a reminder of the net amount a shareholder from a C corporation takes home after taxes without an allocation to goodwill:

	<i>C Corporation</i>
Net income from sale of assets	\$11,000,000
Less 35% corporate tax	\$3,850,000
Net income available to shareholders	\$7,150,000
Less 20% qualified dividend rate ⁷²	\$1,430,000
Net income to shareholders after taxes	\$5,720,000

Next, assume that the total amount paid for the business is the same: \$11,000,000. However, now only \$7,000,000 goes directly to the corporation, and the difference, \$4,000,000, goes to the shareholder directly as “personal goodwill.”⁷³ The shareholder’s net amount after taxes is now \$6,895,400.

	<i>C Corporation</i>	<i>Personal Goodwill</i>
Net income from sale of assets	\$7,000,000	\$4,000,000
Less 34% ⁷⁴ corporate tax	\$2,380,000	0
Net income available to shareholders	\$4,620,000	\$4,000,000
Less 20% qualified dividend rate	\$924,600	\$ 800,000
Net income to shareholders after taxes	\$3,695,400	\$3,200,000
Total Net Income to Shareholder ⁷⁵	\$6,895,400	

Obviously, the benefit to the shareholder in any transaction depends on the amount of the purchase price that is allocated to personal goodwill, but the shareholder will always benefit if some portion of the purchase price isn’t subject to a corporate tax.

72. This refers to the qualified dividend rate for incomes over \$450,000.

73. This allocation is completely arbitrary.

74. As the net income is less than \$10,000,000, the corporate tax rate is 34%. I.R.C. § 11.

75. This table is not an either/or table as were the earlier tables. This table shows the aggregate path of money that go to the shareholder – one through a corporate distribution, and one directly from the seller.

C. MARTIN ICE CREAM V. COMMISSIONER⁷⁶

1. Overview

Any discussion about personal goodwill always starts with the 1998 case of *Martin Ice Cream v. Commissioner*, which opened the doors for personal goodwill to be a component in the sale of assets from a C corporation.⁷⁷ The court in *Martin Ice Cream* held that, in the sale of intangible assets of a business, it is possible under certain circumstances to designate some of those intangible assets as belonging to an individual shareholder rather than the business itself. Although the court in *Martin Ice Cream* never uses the words “personal goodwill” nor does it even refer to the assets that belong to the individual as “goodwill,” this case has long been considered as the first case in which part of the purchase price of a business can be allocated to personal goodwill.⁷⁸ Although cases before *Martin Ice Cream* did hold that personal relationships of an individual shareholder were separate from corporate intangible assets,⁷⁹ a court had not been faced with allocating part of a purchase price in an acquisition to an individual shareholder.

2. Background of the case

The case of *Martin Ice Cream* started with an argument between a father and his son. Arnold Strassberg, the dad, had been in the ice cream distributor business since right after World War II, at about the same time that his son, Martin, was born.⁸⁰ By the 1960s, Arnold had been pretty successful at getting ice cream products into big supermarkets—in fact, he was the one who came up with the idea of packaging ice cream by different brand names, and marketing different ice cream products. Before Arnold started differentiating between different ice cream brands, ice cream had been sold in big generic tubs.⁸¹ Arnold was particularly good at building relationships with his big supermarket customers, but he perhaps was not the best businessperson. In fact, his first ice cream distributor company went belly up in the 1960s⁸² after he lost a major supplier.⁸³

76. 110 T.C. 189 (1998).

77. *Id.*

78. Thomas O. Wells & Daniel Lampert, *Sale of Personal Goodwill – The Executive's Parachute*, 79 FLA. BAR J. 31 (2005).

79. *Martin Ice Cream*, 110 T.C. at 207.

80. Martin Strassberg was born in 1945. *Locate a Person Nationwide*, LEXISNEXIS, PUBLIC RECORDS, last accessed Sept. 12, 2016, <https://advance.lexis.com/publicrecordshome?crd=9821ddde-d0ce-47ae-8832-aa9654475dae>.

81. *Martin Ice Cream*, 110 T.C. at 192.

82. *See id.* (explaining that Arnold formed his first company, Arnold's Ice Cream, in the mid-fifties, but filed for bankruptcy in the 1960s).

In 1971, Arnold decided to start another ice cream distribution company, which he named Martin Ice Cream (“MIC”).⁸⁴ He apparently continued to do what he did well – cultivate and maintain the relationships he had with the big grocery stores. In 1974, the founder (and inventor) of Haagen-Dazs, Ruben Mattus, approached Arnold about using Arnold’s customer relationships to help Haagen-Dazs get into the big supermarkets. Arnold agreed in a handshake, and then he went on to be the first ice cream distributor for Haagen-Dazs, as well as to revolutionize the retail market for premium ice cream.⁸⁵

Meanwhile, Martin, Arnold’s son, started to work for the business—part time at first in 1971, and then full time by 1975. Martin did not like all the schmoozing that his dad had to do with the big supermarkets, so Martin focused on the small independent stores, where all he had to do was supervise the loading of trucks, as he hired route salesmen to do the actual selling.⁸⁶ Martin could remain in the background.⁸⁷

By the late 1970s, Arnold had become so successful with the Haagen-Dazs business that Mattus, the Haagen-Dazs founder, asked Arnold to join him in a partnership on the West Coast. Arnold said no. However, Arnold did want to expand his business on the East Coast. His son, Martin, did not, and that is when the arguments started between them. Arnold and Martin carried this disagreement throughout the 1980s, especially when one of Arnold’s other expansion ideas failed miserably.⁸⁸

Pillsbury purchased Haagen-Dazs from Mattus in 1983.⁸⁹ At about the same time, Ben & Jerry’s, an up and coming premium ice cream producer and a competitor of Haagen-Dazs, asked Arnold to distribute Ben & Jerry’s ice cream.⁹⁰ Arnold, who was still distributing Haagen-Dazs products to four supermarket chains, asked Haagen-Dazs for permission to distribute its competitor’s ice cream, but Haagen-Dazs refused,⁹¹ giving even more weight to the importance of Arnold’s supermarket contacts.

83. *Id.*

84. Initially, Martin owned 100% of the stock of Martin Ice Cream, as Arnold was trying to avoid any lingering bankruptcy claimants. *Id.* In 1979, Arnold became a 51% shareholder. *Id.* However, the record is silent about how he obtained this 51% share, and it ends up not being important to this case.

85. *Martin Ice Cream*, 110 T.C. at 193.

86. *Id.* at 194.

87. *Id.* at 193–94.

88. *Id.* at 196–97.

89. Pamela G. Hollie, *Pillsbury’s Ice Cream Chain Deal*, N.Y. TIMES, June 7, 1983, p. D1.

90. *Martin Ice Cream*, 110 T.C. at 194.

91. This was a common position that Haagen-Dazs took throughout the 1980’s: telling distributors that if they distributed Haagen-Dazs, they could not also distribute Ben and Jerry’s. It did not appear to be a contractual right; rather, it was just something they could insist on because they were a big deal. Ben & Jerry’s sued them several times, including in an anti-trust matter. Haagen-Dazs had even agreed in a settlement with Ben & Jerry’s that Haagen-Dazs would not engage in many of its exclusivity practices. Ben & Jerry’s had to take Haagen-Dazs to court to enforce it. *See Ben & Jerry’s Homemade, Inc. v. Haagen-Dazs Co.*, 693 F. Supp. 1256 (D. Mass. 1987).

One of the first contractual actions that Haagen-Dazs/Pillsbury asked for was that the only premium ice cream that Arnold could distribute was Haagen-Dazs.

In late 1985 or early 1986, Haagen-Dazs again approached Arnold about acquiring access to Arnold's relationships with the supermarkets. The reason for this was two-fold: first, Haagen-Dazs was planning on doing its own distribution from its own distribution centers and second (and most important), Haagen-Dazs wanted to get rid of a potential competitor.⁹²

This offer from Haagen-Dazs came at a good time: at this point, Martin and Arnold were really not getting along, and Martin did not want to work with Arnold any longer.⁹³ Negotiations between Arnold and Haagen-Dazs started in March 1987, which soon broke down and started up again, and ran all the way through May 1988.⁹⁴ Starting in May, the negotiations started in earnest, with proposals given back and forth on paper.

It was what was in these proposals from Arnold that helped the outcome of this case to go towards an allocation of part of the purchase price for intangible assets to go to Arnold personally. An early proposal from Arnold to Haagen-Dazs included \$1.5 million for the business, as well as individual payments to both Arnold and Martin (\$450,000 and \$250,000, respectively) for consulting services and covenants not to compete. Arnold also had the purchase documents show that both, he and his company, Strassberg Ice Cream Distributors, Inc. ("SIC") (a subsidiary that MIC had formed, separating the business into a piece for Martin and a piece for Arnold) were the sellers, and not solely his company.⁹⁵ The finished document stated that all of the Haagen-Dazs distribution rights that would be transferred to Haagen-Dazs were owned by SIC, and also said that Haagen-Dazs was not purchasing any of the non-big supermarket business of MIC.⁹⁶ The final allocation of the purchase price for the assets was \$300,000 for "records" and \$1,200,000 for "Sellers' Rights,"⁹⁷ and the contract had both SIC and Arnold as the sellers. The bill of sale signed by Arnold was for "all existing customer lists, price lists, historical sales records, promotional allowance and rebate records," as well as "other

92. *Martin Ice Cream*, 110 T.C. at 194-96.

93. *Id.* at 197.

94. *Id.*

95. Arnold and Martin had formed a new corporation, Strassberg Ice Cream Distributors, Inc. ("SIC"), which was a wholly-owned subsidiary of Martin Ice Cream ("MIC"). *Id.* at 198. MIC put all its assets relating to the big supermarket business (i.e., not any independent grocery store assets of Martin's side of the business) into SIC. *Id.* at 200. Arnold then gave some of his stock in MIC back to MIC in exchange for all of the stock in SIC. Arnold apparently kept some MIC stock, but the opinion doesn't say how much. *Id.* at 210.

96. *Id.* at 202.

97. *Id.*

business records,” and “the goodwill associated therewith.”⁹⁸ Arnold also signed a document that assigned all of these items to Haagen-Dazs, and he signed it in his capacity as president of SIC as well as for himself individually. Arnold signed a consulting and non-compete agreement with Haagen-Dazs for an additional \$450,000. After the sale closed, Haagen-Dazs wrote a check to SIC (not Arnold) for \$1,430,340,⁹⁹ which is the amount Arnold used when he filed his tax form for SIC, in which he reported that he would be reporting a gain of \$1,430,340 on his personal tax return for 1988.¹⁰⁰ MIC didn’t report anything at all about the sale to Haagen-Dazs when it filed its 1988 return.¹⁰¹

Although the facts of the case are all about Arnold and his relationships with the supermarkets, the eventual Service audit wasn’t of Arnold or SIC, it was of MIC.¹⁰² The Service believed that the \$1,430,340 that went to SIC from Haagen-Dazs should have first been counted as having been constructively received by MIC before being distributed out to SIC. If the Service was right, it would have meant that MIC would have to pay a corporate level of tax on that receipt prior to its distribution to SIC.¹⁰³

3. *The court’s ruling*

Luckily for MIC, the court held that the \$1,430,340 received by SIC was really for intangible assets that were owned only by Arnold, and that those assets had never been owned by MIC.¹⁰⁴ Since those assets had never been corporate assets of MIC, there was no corporate level of tax assessed on MIC.

The factors that led to the court’s decision were:

1. Both Arnold, as an individual, and Arnold, as president of SIC,

98. *Id.* at 204.

99. The final price was reduced to this amount following an agreed-to audit and sales price formula in the purchase agreement. *Id.* at 214.

100. *Id.* at 205.

101. This is interesting because Martin, MIC and Arnold had the same accountant: Rudolph Bergwerk. *Id.* at 204. Another interesting aside is that the Court allowed Bergwerk to be MIC’s expert witness on the value of MIC, even in light of Bergwerk’s work as the accountant for everybody and Bergwerk’s lack of appraiser qualifications, and then Bergwerk screwed up the tax returns of MIC, which MIC ultimately paid a penalty for. *Id.* at 235. Bergwerk was a sole practitioner in the small bedroom community of Livingston, New Jersey, where Arnold and Martin both lived. *Locate a Person Nationwide*, LEXISNEXIS, PUBLIC RECORDS, last accessed Sept. 12, 2016, <https://advance.lexis.com/publicrecordshome/?pdmfid=1000200&crid=aba0d96a-bd6f-41a3-9141-a99713bc14b8&comp=7n5k&prid=c30d8ddd-57ac-4141-9a99-bdc5fb55e8a9>.

102. If MIC’s accountant, Rudolph Bergwerk, had properly filed MIC’s IRS Form 1120S, would the Service have audited MIC? Even if the Service disagreed with the characterization of the proceeds of the sale of assets, the figures on their respective IRS Forms 1120S would have matched for both MIC and SIC, and perhaps not have triggered an audit. See *Martin Ice Cream*, 110 T.C. at 204-05 (outlining several discrepancies in MIC’s IRS Form 1120S).

103. *Martin Ice Cream*, 110 T.C. at 206.

104. *Id.*

signed the purchase agreement documents.¹⁰⁵ This showed that Arnold himself was a party to the sale of assets, so he could properly receive part of the payout.

2. The contract to sell the assets showed two different types of assets: the intangible assets, which the court said belonged to Arnold, and the business records, which the court said belonged to SIC (and therefore had belonged to MIC before those records had been transferred to SIC, and therefore MIC would need to pay corporate taxes on that).¹⁰⁶

3. The personal relationships with the supermarket that belonged to Arnold personally pre-dated the start of MIC¹⁰⁷ (which lent credence to the idea that MIC didn't own those relationships, especially since Arnold had never transferred those relationships to MIC).

4. The success of the supermarket distribution business was dependent entirely on Arnold personally¹⁰⁸ (and therefore those relationships would have no value to MIC if Arnold were not working for MIC).

5. Mr. Mattus (the Haagen-Dazs founder) wanted to partner with Arnold personally, not with MIC.¹⁰⁹

6. Arnold hadn't ever entered into a covenant not to compete or an employment agreement with MIC (which meant that Arnold's personal relationships and distribution expertise had never been transferred to or become the property of MIC).¹¹¹ The court went on to say that even if there had been an agreement, some of the purchase price still would have belonged to Arnold personally, because of Mr. Mattus' desire to work with Arnold personally.¹¹² The lack of an employment agreement and lack of a covenant not to compete between Arnold and MIC is almost universally acknowledged as the main reason for the Court's decision.¹¹³ In subsequent cases, this factor became one of the most important in a court respecting an allocation of personal goodwill to an owner of a corporation.¹¹⁴

7. The disparity between the price paid by Haagen-Dazs to Arnold and SIC and the value of MIC before the split off of the supermarket business¹¹⁵ added to the point that there was excess value that could only have belonged to Arnold, the one variable taken away in the calculation.

105. *Id.* at 204.

106. *Id.* at 206–07.

107. *Id.* at 207.

108. *Martin Ice Cream*, 110 T.C. at 207.

109. *Id.*

111. *Id.*

112. *Id.* at 208.

113. *See, e.g.*, Wells & Bergez, *supra* note 2, at 191.

114. *See Solomon v. Commissioner*, 95 T.C.M. (CCH) 1389 (2008); *see also* Part IV.E.1, *infra*.

115. This is the idea that the difference between the amount paid by Haagen-Dazs and the value of Martin Ice Cream as an on-going business was the premium paid for Arnold personally.

8. The original purchase documents prepared by Haagen-Dazs showed the sellers being Martin, MIC, SIC and Arnold. Arnold had the documents changed to show only SIC and Arnold as the sellers.¹¹⁶ This showed that the parties intended (and thus were part of the negotiations) to have Arnold as a seller.

9. MIC was out of the negotiations a month before the deal closed which gave weight to the idea that this transaction was properly attributed only to SIC and Arnold.

There were two factors that the court downplayed or overlooked in reaching its decision, factors that courts have since found to be extremely important in a finding of personal goodwill: first, the purchase agreement did not allocate the purchase price between Arnold and SIC – in fact, Haagen-Dazs only wrote one check, and it was to SIC.¹¹⁷ The court chose to go with substance over form in order to find that the payment was allocable between Arnold and MIC.¹¹⁸ Although cases since *Martin Ice Cream* that have not allowed an allocation of personal goodwill relied in part on a stated allocation that didn't include personal goodwill, *Martin Ice Cream* can be distinguished because it did not allocate anything at all. Second, there were documents prepared by MIC and Arnold that showed MIC distributing the distribution rights that supposedly were owned by Arnold personally.¹¹⁹ Again, the court went with substance over form, ignoring what the documents themselves said.

So, for the court in *Martin Ice Cream*, the underlying reality of the deal trumped the documents themselves. Interestingly, it was the underlying reality as determined by the court, and not what the parties believed the underlying reality to be, that won the day. Arnold believed that his tax liability came from the distribution of the assets from SIC, and not that the distribution went to him personally.¹²⁰ The result to Arnold would have been less proceeds, and therefore a lesser tax.

Even though the takeaway from *Martin Ice Cream* is typically that goodwill in a corporate acquisition can sometimes be allocated to personal goodwill, *Martin Ice Cream* never discussed personal goodwill. Rather, its holding referred to intangible assets.¹²¹

After *Martin Ice Cream*, what courts have actually given weight to is not the existence or lack of an employment agreement or covenant not to

116. *Martin Ice Cream*, 110 T.C. at 198. The court also noted that it would have viewed this change negatively if it had been at the last minute. *Id.* at 214–15.

117. *Martin Ice Cream*, 110 T.C. at 204, n. 12.

118. *Id.* at 206.

119. The court waved off this problem by holding that “[w]hat petitioner did not own, petitioner could not transfer” rather than using the transfer documents to show evidence of ownership of those assets by MIC. *Id.* at 209.

120. *Id.* at 202.

121. *Id.* at 206.

compete prior to a sale of assets. What the cases have in common is what happened during the negotiations of the asset purchase. As the court said in *Martin Ice Cream*, “[t]he substance of a transaction can be found in the negotiations leading up to the closing.”¹²² This factor is the one that runs through all but one¹²³ of the personal goodwill cases after *Martin Ice Cream*.

Always overlooked in analyses of the *Martin Ice Cream* opinion is the judge who wrote the opinion, Renato Beghe. Judge Beghe had long shown an interest in the income tax treatment of allocations of intangibles in the sale of a business, predating his position as a judge and long before his decision in *Martin Ice Cream*.¹²⁴ Interestingly, Beghe also recommended that parties to an acquisition start talking about allocations to intangibles early in the negotiations in order to back up an allocation to each one,¹²⁵ just as he stated in *Martin Ice Cream*.¹²⁶ This viewpoint is actually what is in the personal goodwill cases that followed.

D. *NORWALK V. COMMISSIONER*¹²⁷

No discussion of *Martin Ice Cream* is complete without talking about its unofficial companion case, *Norwalk v. Commissioner*.¹²⁸ Both cases were decided in 1998, three months apart, and *Norwalk* came out with a similar result to *Martin Ice Cream* in that the court found goodwill to rest with the shareholders rather than the corporation.¹²⁹ However, the decision was not based on negotiations, because this case did not involve an asset sale.

Norwalk was the case that opened the door to the use of goodwill in professional services run through C corporations. *Martin Ice Cream* is actually an anomaly, in that the goodwill held by the individual shareholder, Arnold Strassberg, was for his work as a salesperson. Most personal goodwill cases involve people who are in a professional service industry, e.g., accountants, attorneys, doctors and dentists, as the business of these people is more likely to count on their personal relationships with

122. *Id.* at 212.

123. *See, e.g., Norwalk v. Commissioner*, 76 T.C.M. (CCH) 208 (1998). However, although *Norwalk* dealt with personal goodwill, it was not a sale of assets case.

124. Renato Beghe, *Income Tax Treatment of Covenants not to Compete, Consulting Agreements and Transfers of Goodwill*, 30 TAX LAWYER 587 (1977). Beghe published this article as a partner at the firm of Carter, Ledyard & Milburn in New York, before he became a Tax Court judge. Press Release, United States Tax Court, Obituary for Judge Renato Beghe, July 12, 2012, <http://www.ustaxcourt.gov/press/071312.pdf>.

125. Beghe, *supra* note 123, at 620.

126. *Martin Ice Cream*, 110 T.C. at 215.

127. 76 T.C.M. (CCH) 208 (1998).

128. *Norwalk* was decided after *Martin Ice Cream* by two months, and cites *Martin Ice Cream*. *Id.* at 214.

129. *Id.* at 216.

their customers.

Norwalk is the story of two accountants, Robert DeMarta and William Norwalk, who formed an accounting practice as a professional corporation in 1985,¹³⁰ and what happened when they liquidated that practice and joined another accounting firm.

After forming the corporation, and even though DeMarta and Norwalk were the only shareholders, DeMarta and Norwalk each signed a 5 year employment agreement with the corporation, which also contained a covenant not to compete with the corporation during the term of the agreement.¹³¹ The employment agreement would terminate in 1990, by its terms.

After seven years, which was 2 years after the employment agreement had terminated, DeMarta and Norwalk decided to join the accounting firm of Ireland, San Filippo.¹³² Apparently, the two accountants felt that since they weren't profitable together, they would join a larger accounting firm.¹³³ To accomplish the transition, the DeMarta & Norwalk board of directors (presumably just DeMarta and Norwalk, although the opinion is silent) elected to liquidate the corporation and distribute all of the corporation's assets to its two shareholders.¹³⁴ The only tangible assets that the corporation had were furniture, equipment and accounts receivable, all of which DeMarta and Norwalk later individually contributed to Ireland, San Filippo¹³⁵ for their partnership interests in Ireland, San Filippo.¹³⁶

130. *Id.* at 210. The court opinion shows the name of the corporation as "DeMarta & Norwalk, CPA's, Inc.," but the name of the corporation was actually "De Marta & Norwalk, Certified Public Accountants, an Accountancy Corporation." The correct name shows that the company was a professional corporation under California law, because of the ending 3 words. See Cal. Bus. & Prof. Code § 5150. However, a professional corporation can be an S corporation or a C corporation. From the opinion, we don't know what type of corporation it was.

131. *Norwalk*, 76 T.C.M. (CCH) at 212. The record is silent on why DeMarta and Norwalk chose to enter into this employment agreement. They could have more easily done the same thing with a shareholders agreement, but the cost of drafting that agreement might not have been deductible for the corporation, as the corporation might not have been a party to the shareholders agreement.

132. *Id.* The opinion describes this as DeMarta and Norwalk choosing to liquidate their accounting firm, and then 6 months later, deciding to join Ireland, San Filippo. It begs credulity to say that this wasn't in the works when they decided to liquidate, given the amount of time it would take to liquidate the firm, and the fact that so many employees of the corporation also went to Ireland, San Filippo.

133. Ireland, San Filippo was a large accounting firm (for a regional accounting firm), having 16 partners and 90 employees as of 2009. Press Release, Ireland, San Filippo, (June 4, 2009). Ireland, San Filippo changed its name to Sensiba, San Filippo in 2009. *Ireland San Filippo Announces Name Change to Sensiba San Filippo*, MARKETING BUSINESS WEEKLY, Dec. 20, 2009, at 213. Norwalk is now the "Tax Partner-in-Charge." Press Release, Sensiba, San Filippo, Sensiba San Filippo Appoints William Norwalk Tax Partner-in-Charge, last accessed Sept. 11, 2016, <http://www.ssflp.com/sensiba-san-filippo-appoints-william-norwalk-tax-partner-in-charge/>.

134. *Norwalk*, 76 T.C.M. (CCH) at 213.

135. *Id.* at 212.

136. *Id.* Norwalk and DeMarta valued the equipment and furniture at \$59,455, and their initial capital accounts at Ireland, San Filippo were a total of \$67,243. *Id.* Presumably, therefore, the accounts receivables were valued at \$7,788.

Apparently,¹³⁷ the corporation distributed no intangible assets.

Some facts that were important to the court in deciding this case: first, when DeMarta and Norwalk went with Ireland, San Filippo, so did three other CPAs and five staff.¹³⁸ Within 4 months, two of the three CPAs left to start their own firm, taking at least 92 clients with them.¹³⁹ Five years after the liquidation of the corporation,¹⁴⁰ Ireland, San Filippo had only retained about 10% of the clients that DeMarta and Norwalk had brought with them.¹⁴¹ The court would use these facts to show that there was no goodwill to be had.¹⁴²

After the dust settled, along came the Service, who claimed that the corporation really did distribute intangible assets to Norwalk and DeMarta.¹⁴³ The Service determined that the corporation's client list was worth \$266,000, and corporate goodwill was worth \$369,000,¹⁴⁴ for a total of \$635,000. What makes this different from *Martin Ice Cream* is that in *Martin Ice Cream*, the parties were in disagreement about whom to allocate a distribution of actual cash, but in *Norwalk*, the Service was saying that Norwalk and DeMarta owed taxes on \$635,000, an amount they had never actually received. Also, and obviously, *Norwalk* was not an acquisition where actual money changed hands, as it did in *Martin Ice Cream*.

The court in *Norwalk* held that (1) the corporation had no goodwill to distribute when it liquidated,¹⁴⁵ and (2) that any customer-based intangibles of the corporation belonged personally to Norwalk and DeMarta.¹⁴⁶ Although the court cited *Martin Ice Cream*, it based its opinion more on *MacDonald v. Commissioner*,¹⁴⁷ a case in which the Service also tried to attribute a dollar figure to goodwill in a liquidation in which MacDonald had received no cash. As in *Martin Ice Cream*, the court in *Norwalk* was persuaded by the lack of a covenant not to compete between the

137. The opinion is silent about whether DeMarta or Norwalk distributed any corporate intangibles to themselves, but if they had, it would have likely been in the opinion, since intangibles was the main subject of the opinion.

138. *Id.* at 213.

139. One of the CPAs that left, Thomas Tang, says that he was with Ireland, San Filippo for six months. However, he declines to name them, only referring to them as a "six office regional accounting firm." See *Partner Profiles*, TANG & LEE, LLP, last accessed Sept. 4, 2016, <http://tanglee.com/profile/>.

140. Although the corporation liquidated in 1992, it never dissolved, but it also didn't keep the corporation active. The California Franchise Tax Board suspended the corporation in 2000. The corporation continue to exist, suspended. *Business Entity Detail #C1187124*, CALIFORNIA SECRETARY OF STATE (2016), <http://kepler.sos.ca.gov>.

141. *Norwalk*, 76 T.C.M. (CCH) at 213.

142. *Id.* at 214.

143. *Id.* at 212.

144. *Id.* at 215. The Service's expert determined that the value of the corporation was a total of \$870,000, so that after subtracting the intangibles, there would be \$238,000 remaining. *Id.* The opinion is silent about to what the \$238,000 was attributed.

145. *Id.*

146. *Id.* at 216.

147. 3 T.C. 720 (1944).

corporation and its shareholders or any other agreement between the shareholders and the corporation in which the personal relationships of the shareholder accountants had been transferred to the corporation.¹⁴⁸ The court also may have been swayed by the Service's underhanded method of calculating the value of the intangible assets:¹⁴⁹ first, it based its opinion on the value of the goodwill on an approximation of future earnings, but the cost percentages that the Service plugged into its formula were based on industry standards rather than the actual operating costs of this particular corporation.¹⁵⁰ Second, the Service valued the customer lists and goodwill as though there was a covenant not to compete in place at the time of liquidation,¹⁵¹ even though the covenants not to compete had expired two years prior.

Norwalk is contrasted from *Martin Ice Cream* in that *Norwalk* didn't involve any negotiations for the purchase of the accounting business. The value that the Service attributed to goodwill of the accounting business did not involve cash, so there was no monetary figure for the two accountants to discuss with Ireland, San Filippo. Therefore, negotiations played no part in the court's decision, which is different from how other cases on personal goodwill have been decided.

For the next 10 years after *Martin Ice Cream* and *Norwalk* were decided, very few cases even talked about personal goodwill. However, during that time, commentators were writing about how to use personal goodwill in the sale of corporate assets, relying only on *Martin Ice Cream* and *Norwalk*.¹⁵² Then, starting in 2008, three cases dealt with the issue of personal goodwill,¹⁵³ but those cases received very little attention, and all three courts didn't allow an allocation of personal goodwill. It was not until 2011, with *Howard v. United States*,¹⁵⁴ that personal goodwill was brought back into the limelight.

148. *Norwalk*, 76 T.C.M. (CCH) at 214.

149. This is pure conjecture on the author's part, based on the tone of the opinion when discussing this issue, as well as the background of the judge, Robert Ruwe. Judge Ruwe had worked for the Service as a special agent in the Intelligence Division for 7 years before and during law school, and then for 17 years as an attorney before being appointed to the Tax Court in 1987. *Judge Robert Paul Ruwe*, UNITED STATES TAX COURT, last accessed Sept. 12, 2016, <https://www.ustaxcourt.gov/judges/ruwe.htm>.

150. *Norwalk*, 76 T.C.M. (CCH) at 215.

151. *Id.*

152. *See, e.g.*, Ibrahim, *supra* note 9.

153. *Solomon v. Commissioner*, 95 T.C.M. (CCH) 1389 (2008); *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009); *Kennedy v. Commissioner*, 100 T.C.M. (CCH) 268 (2010); *see* Part IV.E, *infra*.

154. 448 F.App'x 752 (9th Cir. 2011).

E. THE PROGENY OF *MARTIN ICE CREAM*

But first, the 2008–2010 cases: the facts leading up to these cases actually occurred much closer in time to *Martin Ice Cream* and *Norwalk*. These cases showed practitioners struggling with the requirements of having an allocation of personal goodwill be respected by the courts. What happened was that with each case, practitioners tried to use what came before them to try to qualify for this allocation, but none worked.

1. *Solomon v. Commissioner*¹⁵⁵

Solomon was the first personal goodwill case to be decided after *Martin Ice Cream* and *Norwalk*.¹⁵⁶ Unfortunately for the taxpayers in *Solomon*, the court did not rule in their favor as it had for the taxpayers in *Martin Ice Cream* and *Norwalk*.

Solomon was another father-son working together story, with Robert Solomon (the father) and Richard Solomon (the son) selling a portion of their business, Solomon Colors, Inc., to a competitor, Prince Manufacturing Co.¹⁵⁷ The tax court held that the cash Robert and Richard, their wives and Solomon Colors, Inc. (together, the “Solomon Parties”) received in the sale was not for their personal goodwill as they had claimed on their tax returns, but rather was for their covenants not to compete after the sale¹⁵⁸ (which would then be taxed as ordinary income rather than as capital gain). Interestingly, this was not what the Service had asked the court to order, instead, it was a third option determined by the court on its own initiative.¹⁵⁹ The Service maintained that the money that Robert and Richard and their wives received in the sale was attributed to Solomon Color’s sale of its customer list, which was therefore dividend income to

155. 95 T.C.M. (CCH) 1389.

156. Ten years had passed since those cases had been decided, but perhaps it is not surprising that it took ten years for the first case to appear. After *Martin Ice Cream* and *Norwalk* were decided in 1998, taxpayers relying on those cases for subsequent years who would then have had their allocations challenged by the Service would likely not be finally heard for ten years. For example, although *Solomon* was decided in 2008, it was based on issues arising from the 2001 tax year. *Solomon*, 95 T.C.M. (CCH) at 1390.

157. *Id.*

158. *Id.* at 1395.

159. The court did not explicitly state that it was rejecting the Service’s determination and instead, the court described what each side asked for and then went on to say what it found. *Id.* Therefore, understanding the court’s holding can take several read-throughs. Interestingly, Westlaw misunderstood the holding of the court, saying that the court “held that taxpayers received interests in a customer list as distribution from corporation.” *Solomon*, 2008 WL 174406. Lexis had no such problem, saying that “The court held that the \$500,000 and \$140,000 that was allocated to the shareholders’ sale of the customer list was actually attributable to their covenants not to compete.” *Solomon*, 2008 Tax Ct. Memo LEXIS 107.

Robert and Richard.¹⁶⁰

The story starts with Robert and Richard Solomon, along with their wives, six family members and an employee stock ownership plan owning all of the stock of Solomon Colors, Inc.¹⁶¹ One line of business of their company was the production of Mather ore,¹⁶² and only two companies produced it: Solomon Colors and their competitor, Prince Manufacturing. By 2000, the ingredients for Mather ore had been depleted, and the only way to continue production of Mather ore was to use a different type of ingredient that would require a different type of processing equipment. Solomon Colors determined that it would cost about \$1.5 million to replace their processing equipment to continue to produce Mather ore. Since Prince also produced Mather ore, Prince was in the same situation.

Prince then approached Solomon Colors about purchasing Solomon's Mather ore business.¹⁶³ Solomon Colors liked the idea: it would not have to spend the money on new equipment and new processes, and it could use the money from the sale to expand its operations on the West Coast.¹⁶⁴

From the start of negotiations until the closing, the purchase price remained the same: \$1,500,000.¹⁶⁵ What changed during the month of negotiations was the allocation of the \$1.5 million purchase price. The initial term sheet merely said it was for "the Mather ore division of SGS Solomon Colors."¹⁶⁶ The next term sheet said it was for the mill that processed the Mather ore, and a requirement that Solomon Colors stop producing any Mather ore products.¹⁶⁷ Solomon Colors prepared the first draft of the purchase agreement, and it allocated the entire \$1.5 million

160. *Solomon*, 95 T.C.M. (CCH) at 1394.

161. Brief for Petitioners at 9, *Solomon*, 95 T.C.M. (CCH) 1389 (No. 20294-05); Opening Brief for Respondent at 15, *Solomon*, 95 T.C.M. (CCH) 1389 (No. 20294-05).

162. Mather ore, a red iron oxide ore, is used for such things as color in concrete. See Opening Brief for Respondent at 16, *Solomon*, 95 T.C.M. (CCH) 1389 (No. 20294-05). Originally, Solomon Colors was in the business of mining, but as the mines began to deplete, Solomon Colors changed its focus to selling pigment colors in 1972. JANICE A. PETTERCHAK, HISTORIC ILLINOIS: AN ILLUSTRATED HISTORY 124 (2005). Solomon Colors' business is now solely concrete colors. SOLOMON COLORS, INC., <http://www.solomoncolors.com>. They are the largest American-owned producer of iron oxide pigments. PETTERCHAK, *supra*, at 124.

163. The record is silent about why Prince Manufacturing wanted to spend the money to upgrade its equipment and stay in the Mather ore business, and why Solomon Colors would do the opposite. However, it could be because the focus of each company was so different: Solomon Colors was only in the concrete colors business, whereas Prince Manufacturing was more diversified, and serving many different industries as a contract manufacturer in the metal and composites industry. Prince Manufacturing, last accessed on Sept. 6, 2016, <https://www.princemanufacturing.com>.

164. Solomon Colors eventually expanded westward, with two facilities in Rialto, California.

165. *Solomon*, 95 T.C.M. (CCH) at 1391. The case is silent on why the anticipated cost of replacing the Mather ore equipment (\$1,500,000) is identical to the price paid for the sale of the business.

166. *Id.* The "SGS" comes from the prior name of Solomon Colors, which was "Solomon Grind-Chem Services, Inc." Opening Brief for Respondent at 17, *Solomon*, 95 T.C.M. (CCH) 1389 (No. 20294-05).

167. *Id.* at 22.

purchase price to the mill, even though the mill was only worth about \$100,000.¹⁶⁸ After the initial drafts, Prince decided that it wanted the main four Solomon shareholders to enter into a covenant not to compete as a condition of sale.¹⁶⁹

The parties then spent about a month negotiating the final terms of the deal.¹⁷⁰ After that, the deal was then run by inside and outside accountants for Solomon Colors. It was only then that a discussion of allocating the purchase price appears. Although Robert Solomon had talked internally with Solomon attorneys about transferring a customer list as a part of the sale,¹⁷¹ any amounts to be allocated to that customer list wasn't discussed in detail until the accountants became involved. The Solomon Colors accountants suggested various allocations¹⁷² with the principals at Solomon Colors, but it is not clear when this internal discussion began to overlap with discussions with the principals from the Prince side.

In the end, the parties ended up having two agreements: the first was a Purchase and Sale of Covenant Not to Compete Agreement ("PSCNC Agreement") that allocated the \$1,400,000 purchase price¹⁷³ between a covenant not to compete and the customer list: \$700,000 to Solomon Colors (\$150,000 for the entity-level covenant not to compete, and \$550,000 for the customer list), and \$700,000 to the Solomon shareholders, (\$60,000 for the covenant not to compete, and \$640,000 for the customer list). All of the Solomon Parties signed the PSCNC Agreement. The second agreement was a Side Agreement, which had the sale of the mill, as well as the provisions for transferring the Mather ore business from Solomon Colors to Prince. The Side Agreement was only signed by Robert Solomon in his capacity as president, but not individually. However, the

168. *Id.* The reason for this, according to Solomon Colors' attorney, was that it was worried about possible antitrust problem. The antitrust problem would be a perception that Prince and Solomon Colors were forming a monopoly that would increase the prices of its products by virtue of being the only producer in town. *Id.* at 21–22.

169. *Solomon*, 95 T.C.M. (CCH) at 1391.

170. *Id.* at 1391. These negotiations weren't memorialized in drafts of the agreement, rather they were gleaned from internal memos, email exchanges, fax covers to opposing counsel and oral testimony at trial. *See id.* at 391–94 (detailing exchanges throughout memorandum). A major part of the Solomon family's argument was that it wanted more recognition for the oral testimony of the players in the transaction. *See* Brief for Petitioners at 4, *Solomon*, 95 T.C.M. (CCH) (No. 20294-05). It was no surprise that the Service characterized all the testimony as self-serving. *See* Opening Brief for Respondent at 16, *Solomon*, 95 T.C.M. (CCH) 1389 (No. 20294-05).

171. Opening Brief for Respondent at 16, *Solomon*, 95 T.C.M. (CCH) 1389 (No. 20294-05).

172. Among the possibilities was the allocation of \$550,000 to each, the company and Robert Solomon, for the customer lists (where \$400,000 would remain to allocate). Conversely, \$880,000 would be allocated to Solomon Colors, with the remaining \$620,000 being allocated to the four main shareholders.

173. Although the opinion is not clear, apparently Prince Manufacturing paid Solomon Colors \$100,000 at the closing for the Mather ore business, or for the machine. Therefore, the amount being allocated was only \$1,400,000. *See id.* at 12.

PSCNC was incorporated by reference.¹⁷⁴

The Solomon Parties reported the receipt of money from the transaction as long term capital gain for the “Customer List/Goodwill,” and ordinary income for the money attributed to the covenant not to compete for their 2000 tax year.¹⁷⁵ In 2005, the Service determined deficiencies for the Solomon Parties, based on the Service’s position that, despite the plain language in the PSCNC Agreement, Solomon Colors had received the entire amount of the sale, and then distributed money for the customer list to the individual Solomons.¹⁷⁶

Litigation followed, with the court rejecting the positions of both the Solomon Parties and the Service. The court found that the customer list had absolutely no value at all, leaving only the covenant not to compete to be purchased. However, the allocation for Solomon Colors between the customer list and covenant not to compete was respected (Query how the customer list has no value on the one hand, but it has value on the other, when it is the same customer list). For Robert, Richard and their wives, the court decided that since the customer list had no value, the entire \$700,000 that the Solomons had received was for their covenants not to compete.

The court distinguished *Solomon* from *Martin Ice Cream* in several ways: first, it found that the customer relationships between the individual Solomons and their customers unimportant (*Martin Ice Cream* found that the customer relationships between Arnold and the supermarkets was the most valuable asset being purchased); second, the individual Solomons weren’t named as sellers in any of the documents (Arnold was named as a seller of the assets), and third, Prince Manufacturing didn’t require employment or consulting agreements from the individual Solomons (Arnold had signed a consulting agreement along with a non-compete agreement with Haagen-Dazs).

What’s odd about this opinion is that the court cherry-picked facts and law to come to the decision it did, and ignored facts and law that countered its opinion. Some examples:

The court in *Solomon* gave great weight to the fact that the individual Solomons hadn’t signed the Side Agreement in their individual capacities, overlooking that the Side Agreement had incorporated by reference the PSCNC Agreement, which did have the Solomons signing individually.

The court’s determination that the customer list had no value to Prince Manufacturing was key in its finding that 100% of the proceeds that went

174. *Solomon*, 95 T.C.M. (CCH) at 1394.

175. See *id.* at 1394. If the allocation had been respected, the income reporting and its characterization would be correct.

176. In other words, according to the Service, Solomon Colors should have reported the entire \$1,400,000 as income, and the \$700,000 that the individual Solomons received would be a dividend payment to them. See I.R.C. § 301(c)(1).

to the Solomon individuals was for their covenants not to compete.¹⁷⁷ However, the court respected the \$550,000 allocation to the customer list for Solomon Colors.¹⁷⁸ The court never explains how the customer list had value to Prince when it came from the corporation, but it had no value when it came from the shareholders.

Also, *Solomon* cited to *Martin Ice Cream* when it suited its purposes, and ignored any similarity to *Martin Ice Cream* when it did not. For example:

Like *Martin Ice Cream*, the relationships developed by Robert and Richard¹⁷⁹ pre-dated the formation of the corporation.¹⁸⁰ The court in *Solomon* found that Robert and Richard Solomon had developed personal relationships¹⁸¹ just as Arnold had done in *Martin Ice Cream*, but *Solomon* ignored this in its opinion.

Like *Martin Ice Cream*, when the corporation was formed, no intangible assets were transferred to the corporation. *Martin Ice Cream* used this to show that Arnold still owned the intangible assets; *Solomon* used this to show that there were no intangible assets to transfer.¹⁸²

Like *Martin Ice Cream*, neither Robert or Richard Solomon had an employment agreement or a covenant not to compete agreement with their corporation. *Solomon* ignores this similarity.

In *Martin Ice Cream*, even though Arnold signed as an individual signatory, only one check was made out—to the corporation. In *Solomon*, although the individual Solomons didn't sign one of the agreements in their individual capacity, they did receive checks separate from the check to the corporation.

What *Solomon* and *Martin Ice Cream* have in common is the theme that runs through all of the goodwill cases: the amount of negotiations for an allocation to goodwill early in the game, as well as the quality of those negotiations. True, the Solomon Parties did discuss the allocations to goodwill (i.e., the customer lists), but they did it only as part of a discussion on how to make it tax advantaged.

As the *Solomon* case shows, it was not enough for the parties to talk about allocation late in the process, and it was not enough to talk about allocation of goodwill without talking about the value of the goodwill other than as a tax strategy. This is what the subsequent cases show as well – the courts are requiring a substantive discussion/negotiation over the value of the goodwill in order to respect an allocation of part of the purchase price

177. *Solomon*, 95 T.C.M. (CCH) at 1395.

178. *Id.*

179. As well as by Robert Solomon Senior, who had actually started the company in 1927. PETTERCHAK, *supra* note 161, at 24.

180. *Solomon*, 95 T.C.M. (CCH) at 1390.

181. *Id.*

182. *Solomon*, 95 T.C.M. (CCH) at 1395.

towards it.

The court was likely influenced by the Solomon accountants' internal memos, which were all bad facts for the Solomon Parties. One accountant referred to *Martin Ice Cream* and *Norwalk*, and then wrote that personal goodwill didn't fit with the Solomon transaction, saying "as a practical matter, the "goodwill" that is created is arguably more at the entity level, not so much at the individual shareholder-employee level."¹⁸³ The accountant also talked about reducing Robert Solomon's salary and allocating some of the purchase price to account for it.¹⁸⁴ However, the accountant went on to say that the only thing that Prince was buying was the customer relationship,¹⁸⁵ which the court ignored. The accountant's memos only talk about what sort of allocation would pass muster with the Service, and not about the various values of the assets being allocated.¹⁸⁶ A Solomon attorney wrote a memo that Solomon Colors was "doing some creative tax planning by diverting some of the proceeds to the shareholders."¹⁸⁷

2. *Muskat v. United States*¹⁸⁸

This case is barely a blip on the screen of personal goodwill cases, but it does reiterate the idea that negotiations specifically for personal goodwill are key to the court making a finding of personal goodwill. In addition, *Muskat* had a different procedural start than did the other personal goodwill cases: this one did not start from an audit. Rather, it was a claim for refund through the U.S. District Court.¹⁸⁹ The court of appeals affirmed the district court,¹⁹⁰ and found that a payment for a covenant not to compete was not really for personal goodwill. Most of the discussion on goodwill is at the lower court; the court of appeals focused more on the standard of proof to recharacterize income for tax purposes.

Irwin Muskat was the president and a 37% shareholder of Jac Pac Foods, a business started by his grandfather and uncle.¹⁹¹ A subsidiary of Corporate Brand Foods America, Inc. ("CBFA") purchased all of the assets

183. *Id.* at 1392.

184. *Id.*

185. *Id.* at 1391.

186. *See id.* at 1392.

187. *Solomon*, 95 T.C.M. (CCH) at 1392.

188. 554 F.3d 183 (2009).

189. *Muskat v. United States*, No. 06-cv-30-JD, 2008 WL 138052, at *1 (D. N.H. Jan. 10, 2008) [hereinafter *Muskat I*]. At least one commentator queried whether Muskat might have prevailed if he been audited rather than seeking a refund. David E. Kahen & Elliot Pisem, *Sale of Closely Held Business: Allocations of Consideration*, N.Y. L.J., Feb. 18, 2009, <http://www.newyorklawjournal.com/id=1202428381075?keywords=Kahen+Pisem+Allocations>.

190. *Muskat*, 554 F.3d at 187.

191. *Id.*

of Jac Pack for \$34 million, which included about \$15 million for business goodwill. In addition, and in a separate agreement, CBFA agreed to pay Irwin personally about \$5 million for a covenant not to compete, of which \$1 million was paid on closing. Irwin listed the \$1 million payment as ordinary income on his 1998 tax return. In 2002, Irwin filed a claim for a refund of \$203,434,¹⁹² claiming he mistakenly characterized the payment as ordinary income, when it should have been characterized as a long term capital gain because the payment was really for his personal good will.¹⁹³

Irwin's problem was that there was absolutely nothing in the record that could be used to recharacterize the payment for the covenant not to compete as a payment for personal goodwill. Personal goodwill was never mentioned in the negotiations, it was never mentioned internally and it appears as if no one thought of this characterization until the claim for refund in 2002.¹⁹⁴ Irwin tried to pull everything out of the agreements that he could to try to make the argument that the payment was really for personal goodwill, but he could not even come close. In addition to the agreements being silent on personal goodwill, as well as the negotiations being silent on personal goodwill, CBFA's president testified at trial that there was no other goodwill than the business goodwill that CBFA had specifically purchased. Irwin didn't stand a chance.

3. Kennedy v. Commissioner¹⁹⁵

Kennedy is another off-the-radar case that falls in line with the previous cases: that failure to negotiate up front for an allocation of part of the purchase price to personal goodwill kills its chances of that allocation being respected by the Service.

James Kennedy ("Kennedy") was an employee benefits consultant running his own business as a C corporation, KCG International, Inc. when he began to consider selling his business in early 2000.¹⁹⁶ In the summer of 2000, Ed Mack ("Mack") of Mack and Parker, Inc. ("M&P"),¹⁹⁷

192. *Id.* The payment broke down as \$176,652 as ordinary income tax, and \$26,782 as self-employment tax. *Id.* n.2. Unfortunately for Irwin, he didn't initially make a separate claim for a refund of the self-employment tax, so the appellate court didn't allow a refund. *Id.* at 195. It is likely that that Irwin would have won the self-employment tax refund claim.

193. Complaint at 18, *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009) (No. 08-1513).

194. One reason that no one thought of it or talked about it in 1998 may have been because *Martin Ice Cream* was so new. *Martin Ice Cream* was decided in March 1998. 110 T.C. at 189. In contrast, the *Muskat* asset sale occurred only 2 months later in May 1998. 554 F.3d at 187.

195. *Kennedy v. Commissioner*, 100 T.C.M. (CCH) 268.

196. Opening Brief for Petitioners at 19, *Kennedy*, 100 T.C.M. (CCH) 268 (No. 2180-08).

197. Mack & Parker Inc. was a subsidiary of Hub International Limited, an international insurance brokerage. Press Release, Hub Int'l, Hub International Limited and Its Subsidiary Mack and Parker Announce Acquisition of Kennedy Consulting Group (Apr. 21, 2001) (on file with author). Mack & Parker changed its name to Hub International Illinois in October 2004. Press Release, Hub Int'l, Mack and Parker, Inc. Changes Name to HUB International Illinois (Oct. 4, 2004) (on file with author).

approached Kennedy about M&P purchasing Kennedy's business,¹⁹⁸ and on October 31, 2000, the parties closed the deal.

At the start of the negotiations during the summer, Mack and Kennedy discussed the purchase price for the business, without discussing what M&P would actually be purchasing.¹⁹⁹ As Kennedy would continue to work for M&P after the purchase of his business, Mack and Kennedy decided early on that the purchase price would be based on 150% of Mack's predicted annual income once at M&P, with only the payment schedule left to determine.²⁰⁰ It wasn't until September, after M&P sought legal advice on the transaction, that the parties gave any thought to the actual structure of the transaction. M&P's attorney, Jerry Roberts, contacted a tax accountant to look for ways to "enhance the tax benefits," and then Roberts wrote an email to Mack, listing the various structures that M&P might use and their tax consequences.²⁰¹ At the end, Roberts suggested that M&P could "take the position that Kennedy owns [his corporation's] customer list and the good will with the customers and hence could sell them directly to M&P."²⁰² Ultimately, it was this email, and the fact that the ultimate structure included a sale of the customer list, that caused the court to find that there was not any personal goodwill in this transaction.²⁰³ As the court stated, the "goodwill was a tax motivated afterthought that occurred late in the negotiations."²⁰⁴

Many commentators since *Kennedy* have focused on the court's statement that "[w]e find it significant that there is a lack of economic reality to the contractual allocation of the payments to goodwill."²⁰⁵ However, the reason the court found a lack of economic reality in *Kennedy* was that the parties did not negotiate for it. If the parties had ended up with the exact same purchase price but also showed that they discussed the allocation at the start of the negotiations, query whether the court would have still found a lack of economic reality.

There was one oddity in this case: the court held that Kennedy would be liable for self-employment taxes on the amounts he received from the sale of assets. What made this unusual is that the court first stated that because payments for a covenant not to compete are ordinary income just

198. Opening Brief for Petitioners at 20, *Kennedy*, 100 T.C.M. (CCH) 268 (No. 2180-08).

199. *Kennedy*, 100 T.C.M. (CCH) at 269.

200. *Id.*

201. *Id.* The Kennedys were also assessed an accuracy related penalty. However, because the Kennedys reasonably relied on Roberts, who consulted a tax attorney he relied on for advice, the court concluded that the Kennedys were not liable for the penalty. *Id.* at 275.

202. *Id.* at 269.

203. *See id.* at 273.

204. *Id.* at 274.

205. *See e.g.*, Robert F. Reilly, *Kennedy v. Commissioner: Income Tax Consequences of Structuring the Company Purchase/Sale Transaction*, INSIGHTS 64 (2011). *See also* Charles J. Reichert, *Sale of Business Generates Ordinary Income*, 211 J. ACCT. 57 (2011).

as payment for services are ordinary income, the court did not need to allocate the payments between services and noncompetition obligations.²⁰⁶ However, although both are ordinary income, only payment for services is also subject to self-employment tax.²⁰⁷ The court apparently did not know about this distinction, as it went on to say that simply because it had decided that the payments were ordinary income, the payments were necessarily includable in self-employment income.²⁰⁸

F. *HOWARD V. UNITED STATES*²⁰⁹

Unlike the cases after *Martin Ice Cream* cited above, *Howard v. United States*²¹⁰ was the first case since *Martin Ice Cream* and *Norwalk* that got a lot of attention,²¹¹ perhaps because it was the first case after 1998 that dealt with a professional corporation, but also perhaps because it was read as the opposite result of *Norwalk*,²¹² as both cases dealt with professional practices, but came up with different results.

Larry Howard was a dentist who wanted to start the transition to retirement at the relatively young age of 55.²¹³ He had been practicing as a dentist since 1972, and operating his dental practice as a C corporation since 1980.²¹⁴ Dr. Howard ran the corporation as one should: he ran everything through it, e.g., the payroll, malpractice insurance, reimbursement of his expenses. In addition, in what would turn out to be the deciding factor in his case, and for no apparent reason,²¹⁵ Dr. Howard entered into an employment agreement as well as a covenant not to compete agreement with his new corporation. In the detailed 10 page agreement,²¹⁶ among other things, Dr. Howard agreed to not compete with

206. *Kennedy*, 100 T.C.M. (CCH) at 274.

207. I.R.C. § 197(d)(1)(E).

208. *Kennedy*, 100 T.C.M. (CCH) at 275.

209. *Howard v. Commissioner*, 106 A.F.T.R.2d 5533 (2010), *aff'd*, 448 Fed. Appx. 752 (2011).

210. *Howard*, 106 A.F.T.R.2d 5533.

211. See Mark L. Silow, *Goodwill and Professional Service Corporations*, 244 LEGAL INTELLIGENCER 5 (2011).

212. Scott E. Vincent, *Ninth Circuit Rejects Personal Goodwill Allocation in Sale of Professional Practice*, 67 J. MO. BAR 309 (2011).

213. Howard was born in 1946. *Provider Credential Search for Larry Eugene Howard*, WASH. STATE DEP'T OF HEALTH, last accessed Sept. 2, 2016, <https://fortress.wa.gov/doh/providercredentialsearch/SearchCriteria.aspx>.

214. The corporation was formed as a Professional Service Corporation under the Revised Code of Washington, Title 18, 18.100.010 *et seq.*, on October 1, 1980. LEXISNEXIS, WASH. SEC'Y OF STATE CORP. FILING RECORDS (on file with author).

215. There is no business or tax reason for the sole shareholder of a corporation to enter into an employment agreement with that corporation. Others have noted this as well. See, e.g., Silow, *supra* note 210, at 5.

216. Memorandum in Support of United States' Motion for Summary Judgment at Section A, January 15, 2010, *Howard v. United States*, 106 A.F.T.R.2d 5533 (2010) (E.D. Wash. Jan. 30, 2010) (No. 08–365).

his corporation, including for an additional 3 year period after no longer owning stock in the company.²¹⁷

In 2002, Dr. Howard put his business up for sale with a business broker, and attracted a young dentist from South Dakota, Bryan Finn.²¹⁸ When Dr. Finn decided to purchase the practice, he had not discussed anything about the structure of the purchase; rather, he had only been presented with a total price, which he accepted.²¹⁹ Apparently, someone other than Dr. Finn or Dr. Howard decided how to allocate the purchase price, and then presented a summary of what the allocation meant to both dentists.²²⁰ The final purchase price was \$613,000, with \$549,900 allocated to Dr. Howard's personal goodwill,²²¹ \$16,000 allocated to Dr. Howard for a covenant not to compete with Dr. Finn's practice,²²² and \$47,100 allocated to Dr. Howard's corporation for equipment and miscellaneous assets.²²³ Dr. Howard and his wife, Joan, filed their 2002 federal tax return, reporting \$320,358 as long term capital gain.²²⁴

For three years following the purchase by Dr. Finn, Dr. Howard continued to work as a dentist, but only part time,²²⁵ and was paid through his corporation (not Dr. Finn's). Dr. Howard's corporation paid him \$110,000 per year, and he continued to receive benefits from his corporation.²²⁶ The Service subsequently audited the Howards' tax return, recharacterized the sale of the goodwill as a corporate asset, treated the amount received by the Howards as a dividend from Dr. Howard's corporation and then charged the Howards with a deficiency.²²⁷ The

217. *Id.*

218. DR. BRYAN FINN, SPOKANE DENTIST, WASH., http://www.newexpressionsdental.com/about_us/Dr_Bryan_K_Finn.htm.

219. *Howard*, 106 A.F.T.R.2d 5533, at 9.

220. See Memorandum in Support of United States' Motion for Summary Judgment at Section A, January 15, 2010, *Howard v. United States*, 106 A.F.T.R.2d 5533 (2010) (E.D. Wash. Jan. 30, 2010) (No. 08-365). Dr. Howard's attorney used the passive voice in explaining the summary ("A 'summary' of the proposed Asset Purchase Agreement was provided to the parties"). What's interesting is that the summary was provided to both parties, indicating that a broker handled the transaction for both parties, without either having an attorney.

221. *Howard*, 106 A.F.T.R.2d 5533, at 3.

222. *Id.*

223. United States' Response in Opposition to Plaintiffs' Motion for Summary Judgment at Background, *Howard v. United States*, 106 A.F.T.R.2d 5533 (2010) (E.D. Wash. Jan. 30, 2010) (No. 08-365).

224. *Howard*, 106 A.F.T.R.2d 5533, at 4.

225. *Id.* One of Dr. Howard's hobbies was restoring old aircraft, at which he apparently spent much of his free time. Following the sale of his dental practice, he flew in the 2003 National Air Tour, an organization that recreates the 1925-1931 National Air Tours. See *Planes, Pilots & People of the 2003 tour!*, NATIONAL AIR TOUR, <http://www.nationalairtour.org/pilotplanespeople/>.

226. Although the record is silent on the financial structure of the practice after the sale to Dr. Finn, it is likely that Dr. Howard kept his name on the business in order to assist Dr. Finn in passing the business over to Dr. Finn, and that there was some sort of calculation for how much money coming into the practice went directly to Dr. Howard's corporation.

227. *Howard*, 106 A.F.T.R.2d 5533, at 4.

Howards paid the deficiency, and then made a claim for refund.²²⁸

In recharacterizing the goodwill as a corporate asset, the Service focused primarily on Dr. Howard's employment and covenant not to compete agreement between him and his corporation.²²⁹ The Service went through a litany of rights that Dr. Howard's corporation had because of those agreements, and determined that since the corporation owned all of the assets and rights of the corporation, it necessarily owned all of the goodwill as well.²³⁰ Interestingly, when the Service made the argument that "courts look for employment agreements and covenants not to compete, which by their very existence, make the relationships developed by the employee the property of the corporation,"²³¹ it cited no cases for that proposition. Later in its argument, the Service cited statements in *Martin Ice Cream* and *MacDonald v. Commissioner*²³² that the absence of employment agreements means that the personal goodwill (or a taxpayer's ability, in *MacDonald*) is not owned by the contracting corporation. However, *Martin Ice Cream* and *MacDonald* never said that – rather, they only used the lack of employment agreements as evidence that the personal goodwill did not belong to the corporation.

On the other side, the first argument made by Dr. Howard was to analogize to dissolution of marriage cases, in which the value of the personal goodwill of a spouse in a professional practice is divided between the spouses.²³³ The court never addressed this argument other than to say that the Howards made it, perhaps because valuing the goodwill of a community property interest was irrelevant to a discussion of personal goodwill belonging to a corporation or an individual.^{234,235} The Howard case was dealing with federal income tax law, and its attorney was arguing state community property law.

The second argument made by Dr. Howard was that the asset purchase agreement clearly allocated the purchase price. The court promptly dismissed this argument, based on the substance over form concept of the personal goodwill cases, because the agreement did not reflect the

228. *Id.* The case was actually a decision of two competing summary judgment motions, as the Howards and the Service agreed on all the material facts.

229. Memorandum in Support of United States' Motion for Summary Judgment, January 15, 2010, *Howard v. United States*, 106 A.F.T.R.2d 5533 (2010) (E.D. Wash. Jan. 30, 2010) (No. 08–365).

230. *Id.*

231. *Id.* at Argument.

232. *MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944).

233. *Howard*, 106 A.F.T.R.2d 5533, at 8.

234. The Howards' attorney was Gary Randall, of Workland & Witherspoon, he was primarily a tax and community property attorney, and taught classes on these subjects at Gonzaga University for over 30 years. Gary Randall, WORKLAND & WITHERSPOON, <http://workwith.com/gary-c-randall/>.

235. *Howard*, 106 A.F.T.R.2d 5533, at 9. In fact, the court gave such short shrift to the dissolution analogy that when it came to discussing the Howards' third argument, the court labeled it as the Howards' second argument.

relationship between Dr. Howard and Dr. Finn.²³⁶ The court was influenced not just by the lack of negotiations for the allocation, but the fact that the allocation had not even been mentioned at all.²³⁷

Dr. Howard's third argument, which might be characterized as clutching at straws, was that when Dr. Howard sold his business, that action necessarily terminated the employment and covenant not to compete agreement. Dr. Howard's theory was that since he could have modified the agreement at any time, the sale of the company did just that.²³⁸

The Court went with the Service. In addition to ignoring the dissolution case law presented by the Howards and dismissing out of hand the idea that what the contract explicitly says should control the allocation, the court went with the existence of the employment and covenant not to compete agreement to mean that the goodwill was a corporate asset. It added that even if the sale of assets to Dr. Finn terminated the employment and covenant not to compete agreement, the goodwill accumulated during the existence of the agreement stayed with the corporation.

Howard, then, added to the personal goodwill list of things not to do in order to have an allocation of personal goodwill respected.²³⁹

*G. H & M, INC. v. COMMISSIONER*²⁴⁰

As a post script to *Howard*, *H & M* tangentially tackled personal goodwill, and reiterated the basic ideas of *Martin Ice Cream* and *Norwalk*: that when the business of a corporation depends on the personal relationships of a key individual, there is no corporate goodwill to be sold (*Martin Ice Cream*) absent a transfer of that goodwill to the corporation (*Norwalk*).²⁴¹ And, what made this case interesting was that personal goodwill was not even brought into the case until *H & M*'s post trial brief.²⁴²

Howard Schmeets was the King of Insurance in Harvey, North Dakota.²⁴³ He had been a successful insurance agent in Harvey since the late 1960s, and by 1980, he was the sole shareholder of Harvey Insurance Agency, Inc., a North Dakota corporation.²⁴⁴ However, despite Mr.

236. *Id.*

237. *Id.*

238. *Id.* at 9–10.

239. See, e.g., Charles J. Reichert, *Whose Goodwill Is it?*, JOURNAL OF ACCOUNTANCY, Oct. 31 2010, <http://www.journalofaccountancy.com/issues/2010/nov/goodwill.html>.

240. *H & M, Inc. v. Commissioner*, 104 T.C.M. (CCH) 452.

241. *Id.* at 457–58.

242. Petitioner's Post Trial Brief at 41–42, *H&M*, 104 T.C.M. (CCH) 452 (No. 16612-09).

243. *H & M*, 104 T.C.M. (CCH) at 452.

244. *Id.* After the sale of the corporation, Mr. Schmeets changed the name to *H&M, Inc.* *Id.* at 455. They apparently had no problem with using the same name of the retail clothing store: in Mr. Schmeets's case, the "H" and "M" stand for Harvey and Mona Schmeets.

Schmeets' local success, he was still a relatively small Midwestern rural player in the national insurance game. When large, national insurance companies began to demand more volume from insurance agencies in the 1990s, Mr. Schmeets could not keep up.

Luckily, another competitor in town with whom Mr. Schmeets had a history was experiencing the same problem, so the two started talking about combining.²⁴⁵ Negotiations ensued, and Mr. Schmeets decided to sell his company to the competitor, an agency within the National Bank of Harvey (the "Bank"). Mr. Schmeets' biggest concern was to be able to have continued employment, so the deal was structured to pay him \$20,000 for the assets, along with a six year employment contract with a non-compete and some deferred comp thrown in.²⁴⁶ At the end of the day when the agreement was signed in 1992, the package was worth about \$600,000.²⁴⁷

Everything went off as planned: Mr. Schmeets worked for the new agency for six years, and he got all of the money he was entitled to. At the end of the six years, Mr. Schmeets retired.

After an audit, the Service sent a deficiency notice to H&M claiming, among other things, that the salary and deferred compensation Mr. Schmeets received were actually payments to the corporation for the insurance business.²⁴⁸ The Service therefore assessed the corporation for capital gain and interest income for the now-recharacterized salary and deferred compensation payments.²⁴⁹ H&M paid the deficiency, and then petitioned for a re-determination of the deficiency.

During the trial, the Service made what H&M called a "reverse valuation"²⁵⁰—after not contesting that the assets had a value of \$20,000, the Service claimed that the excess must be attributed to the corporation's goodwill,²⁵¹ claiming that substance over form requires this allocation.²⁵²

H&M rebutted that in its post-trial brief, noting that if it was goodwill at all, it was personal goodwill. Interestingly, it used the argument that other cases have used against personal goodwill: that since there was no valuation of the corporation, no discussion of tax consequences or benefits, and no discussion at all of the allocation of the purchase price, the Service cannot now claim that there was goodwill attributable to the corporation.²⁵³

245. *Id.* at 454.

246. *Id.*

247. *Id.*

248. *H & M*, 104 T.C.M. (CCH) at 456. Presumably the statute of limitations hadn't passed, as the parties had renegotiated the contract in 1993, and Mr. Schmeets deferred his compensation even further into the 2000s. In fact, the audit was for the years 2001 through 2005.

249. *Id.*

250. Petitioner's Post Trial Brief at 40, *H & M*, 104 T.C.M. (CCH) 452 (No. 16612-09).

251. *H & M*, 104 T.C.M. (CCH) at 456.

252. *Id.*

253. Petitioner's Post Trial Brief at 40-42, *H & M*, 104 T.C.M. (CCH) 452 (No. 16612-09).

In addition, H&M argued that the testimony at trial also showed that the insurance business was personal to Mr. Schmeets: that it was Mr. Schmeets who was well known and not his agency, that business came to Mr. Schmeets, and not the corporation itself, that the sale would not have happened if Mr. Schmeets had not agreed to be employed by the Bank after the sale. The idea, H&M said, was that the Bank would not have just purchased the Harvey Insurance Agency, it wanted Mr. Schmeets.²⁵⁴ H&M also tackled the substance over form argument, by pointing out that the substance of the transaction did match the form: that both parties treated the deal as an employment relationship, and that there were no facts to back up any other allocation.²⁵⁵

The court fully bought H&M's argument that the compensation was not goodwill belonging to the corporation.²⁵⁶ However, it limited its holding only to finding that the payments to Mr. Schmeets were not disguised purchase-price payments to H&M.²⁵⁷ Although the court believed that part of the compensation should have been allocated to Mr. Schmeets for personal goodwill, it made no finding as Mr. Schmeets' tax liability was not before the court.²⁵⁸

This case will likely be cited in the future for personal goodwill cases, as it has a good exposition of the personal goodwill doctrine, starting with a longer-than-typical explanation of *MacDonald v. Commissioner*²⁵⁹ and *Newark Morning Ledger*²⁶⁰ and a review of holdings that found personal goodwill.

F. *BROSS TRUCKING, INC. v. COMMISSIONER*²⁶¹

The recent case of *Bross Trucking, Inc. v. Commissioner* revived the conversation about who owns the goodwill in the distribution of assets from a corporation. *Bross Trucking* went into great detail about the attributes of personal goodwill v. corporate goodwill²⁶² and found that the corporation had no goodwill to distribute.²⁶³ *Bross Trucking* defined personal goodwill in an overbroad manner out of sync with previous cases,

254. *Id.*

255. *H & M*, 104 T.C.M. (CCH) at 457.

256. *Id.*

257. *Id.* at 458.

258. *H & M*, 104 T.C.M. (CCH) at 458. It actually would have been better for Mr. Schmeets if he had allocated part of the compensation to personal goodwill, as the personal goodwill would have had capital gains treatment, and his compensation not only was ordinary income, but subject to employment taxes as well.

259. *MacDonald v. Commissioner*, 3 T.C. 720 (1944).

260. *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993).

261. *Bross Trucking, Inc. v. Commissioner*, 107 T.C.M. (CCH) 1528.

262. *Id.* at 1532–35.

263. *Id.* at 1535.

stating that it is when “all of the goodwill is attributable solely to the personal ability of the [individual].”²⁶⁴ Nevertheless, this case is all the rage for commentators to find this is a continuation of *Howard* and *Martin Ice Cream*.²⁶⁵

Bross Trucking involved a bunch of companies owned by one guy—Chester Bross. Bross Trucking was one of those companies—and the trucking company’s main customers/suppliers were all family members of Chester Bross. After Bross Trucking got into some trouble with the Department of Transportation after some audit and financial problems, Chester decided to shut down Bross Trucking, and have his three sons start a new trucking company, LWK Trucking.²⁶⁶ Although LWK expanded into areas that Bross Trucking hadn’t entered, it still continued the exact same business done by Bross Trucking, which involved using the same customers as Bross Trucking (which customers were all family owned).²⁶⁷ The Service claimed that what had happened, in effect, was that Bross Trucking had distributed all of its intangible assets in Bross Trucking to Chester (a taxable event), and then Chester transferred those intangible assets to LWK (a gift tax event), both of which were not included in Bross Trucking or Chester’s tax returns for 2004, the year in which LWK was formed.

Basing its reasoning on its analysis of *Martin Ice Cream* and *Solomon*, the court determined that Bross Trucking’s goodwill was “primarily owned by Mr. Bross personally, and the company could not transfer any corporate goodwill to Mr. Bross.”²⁶⁸

The court in Bross made several interesting, but questionable points:

1. The court seemed to have two definitions of goodwill—the first was for corporate goodwill, as “the expectation of continued patronage,”²⁶⁹ which the court seemed to limit to the value (or negative value) of the “Bross” name.²⁷⁰ However, the definition in the regulations includes “any other factor”²⁷¹ that would contribute to an expectation of continued patronage, a much broader standard. The second type of goodwill only applied to personal goodwill, and that was defined as personal relationships

264. *Id.* at 1533.

265. *See, e.g.,* Risius, & Stumpf, Aaron, *supra* note 10.

266. Chester did consider having his three sons use Bross Trucking. Opening Brief for Respondent at 30, *Bross*, 107 T.C.M. (CCH) 1528 (No. 7710-11). However, on advice of counsel, Chester and his sons decided to form a new company. *Bross*, 107 T.C.M. (CCH) at 1530.

267. *Bross*, 107 T.C.M. (CCH) at 1530.

268. *Bross*, 107 T.C.M. (CCH) at 1532.

269. Although goodwill is defined in section 1.197-2(b)(1) of the regulations, the court only used definitions from cases, such as *Network Morning Ledger Co. v. United States*, 507 U.S. 546, 555 (1993). *See Bross*, 107 T.C.M. (CCH) at 1532.

270. *Bross*, 107 T.C.M. (CCH) at 1533.

271. Reg. § 1.197-2(b)(1).

between a shareholder and customers/vendors.²⁷² The court then expanded personal goodwill to mean anything that was due to the personal ability of a shareholder.²⁷³ There are not two types of goodwill: there is only one, and the only question is who the goodwill belongs to.

2. The court made specious arguments about the relationship between Bross Trucking and LWK. It noted that customers did not trust Bross Trucking and would not want to continue doing business with it,²⁷⁴ that LWK would want to hide the Bross logo from customers,²⁷⁵ that customers of Bross Trucking only did business with it due to having personal relationships with customers²⁷⁶ and “Bross Trucking’s customers had a choice of trucking options and chose to switch from Bross Trucking to LWK Trucking,”²⁷⁷ all the while pretending that the customers and Bross Trucking were not all in the same family.

3. The court had a very narrow version of the definition of a covenant not to compete, saying that it had to be a signed noncompete agreement.²⁷⁸ However, the regulations are somewhat broader, saying that it can also be an arrangement that “has substantially the same effect as a covenant not to compete.”²⁷⁹ Since the arrangement was clearly that LWK would take over doing the work that Bross Trucking had been doing, and since the family owned all of these companies, the effect was the same as if Bross Trucking or Chester had signed a covenant not to compete.

4. Even if LWK did not receive any goodwill from Bross Trucking, it certainly received it from Chester. The result would be that Chester would not pay taxes on a distribution from Bross Trucking, but he certainly should have accounted for the gift of the personal goodwill to his sons, which the court did not discuss.

Although this case does not really add anything to the personal goodwill discussion and, in fact, it may only muddy the waters, it has had the effect of lawyers and accountants discussing personal goodwill more frequently than we have seen in recent years.

272. *Bross*, 107 T.C.M (CCH) at 1533.

273. *See id.* (“A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee.”).

274. *Id.*

275. *Id.*

276. *Id.*

277. *Id.* at 1535.

278. *Id.* at 1534.

279. I.R.C. § 179(d)(1)(E).

V. WHAT IS A SELLER TO DO? ADDING A LEGISLATIVE FIX

A comprehensive look at the details in the personal goodwill cases show that adherence to one definitive list that decides whether goodwill is personal or belongs to the company does not work, and attorneys and accountants who rely on it are not standing on solid ground. Some cases emphasize non-compete agreements with the buyer (= personal goodwill), or employment agreements with the seller (\neq personal goodwill), others emphasize personal relationships pre-dating the start of the company. But one thread that does run through all of these cases: when in the process did the buyer and seller first talk about personal goodwill? If the parties talk about it only after negotiations on price have concluded, including only mentioning it once litigation has started, courts will not call it personal goodwill. If the parties never talk about it but have talked about things that include facts that support a goodwill designation (e.g., signing the agreement individually or purchase price in drafts shows an allocation for an individual), a goodwill designation sometimes holds.²⁸⁰ A second factor that runs through the cases is how the individual judge deciding the case feels about the litigants, their arguments, or personal goodwill. Query whether the idea of personal goodwill would ever have taken a foothold if the judge in *Martin Ice Cream* had not been really interested in that topic to begin with.²⁸¹

A seller's use of personal goodwill should not be dependent on their knowing about it before they start to negotiate a deal, or whether they were lucky enough to not have introduced it into the conversation after the fact. Sellers should have some assurance that a contractually agreed-on allocation, supported by statutorily defined back-up data, will be respected by the Service, and not be subject to second guessing or to looking behind the contract. In the cases since *Martin Ice Cream*, the futures of the taxpayers rose and fell on the timing that they asked about using personal goodwill as an allocation of part of their purchase price, their foolhardy choice to consider tax savings as a reason for considering the use of personal goodwill and how they chose to memorialize their work in their business before even thinking about selling. The outcomes have sometimes matched the reality of the business, but other times, not so much.

Just as section 197 was enacted to, among other reasons, bring certainty to taxpayers in the amortization of their intangible assets, so too can legislation bring certainty to taxpayers (and the Service) in the allocation of goodwill in a sale of assets. Simple legislation could be crafted to allow this allocation, with the taxpayer instructed to provide the

280. *Martin Ice Cream* is the best example of this: it had more factors weighing in the direction of personal goodwill, without Arnold Strassberg ever having thought about it.

281. *Martin Ice Cream v. Commissioner*, 110 T.C. 189, 202 (T.C. 1998).

backup that a synthesis of the factors in the personal goodwill cases now require. These factors are

1. Appraisal of the personal goodwill (with certifications similar to those required by appraisals for gift and estate taxes, using the language from section 170).

2. A covenant not to compete and/or consultant agreement between the buyer and the individual shareholder of the seller (to make the transfer of the personal goodwill effective).

3. Attestation that the shareholder has not transferred any intangible assets that would give rise to the corporation owning the goodwill (e.g., no employment agreement or covenant not to compete with the shareholder's own corporation).

4. Agreement for sale of assets to be signed by both the corporation and the individual, with the allocation spelled out in the contract.

The appraisal by a certified appraiser would take care of any trumped up personal goodwill claims. This safe harbor for a personal goodwill allocation would also allow sellers the opportunity to negotiate for allocating part of the purchase price to personal goodwill without worrying that their record will show that negotiations didn't start early enough. Having a specific statute for an allocation of personal goodwill will also serve to allow all sellers the opportunity to use this allocation if it fits their circumstances, rather than limiting it to the sellers with sophisticated lawyers or accountants.

VI. CONCLUSION

Martin Ice Cream and the cases that followed has meant that it is a crap shoot for a seller of assets allocating part of the purchase price to an individual's personal goodwill rather than to the corporation. Tax consequences should not depend on the whims of any particular judge, or at what point in the negotiations the parties discussed allocation of goodwill. Contracts with tax allocations supported by appropriate backup entered into between two willing participants shouldn't be so easily discarded. As the allocation of part of a purchase price of assets to the personal goodwill of a shareholder is allowed under current law, its usage should be standard and predictable, which it currently is not. Although commentators have developed a list of criteria for the availability of an allocation to personal goodwill, case law shows that the availability is more arbitrary than commentators say. A legislative fix to establish standards for its usage would allow predictability and reduce uncertainty for taxpayers, as well as reduce the costs of litigation for this unsettled area of law.